S. Hrg. 99-371

FEDERAL ENERGY REGULATORY COMMISSION'S NATURAL GAS PIPELINE REGULATION

HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY REGULATION AND CONSERVATION

OF THE

COMMITTEE ON
ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON THE

FEDERAL ENERGY REGULATORY COMMISSION'S REGULATION OF NATURAL GAS PIPELINES AFTER PARTIAL WELLHEAD DECONTROL

SEPTEMBER 19, 1985

Printed for the use of the
Committee on Energy and Natural Resources

U.S. GOVERNMENT PRINTING OFFICE
55-233 O WASHINGTON : 1986

55-233 O - 86 - 1

S311-19

COMMITTEE ON ENERGY AND NATURAL RESOURCES

JAMES A. McCLURE, Idaho, *Chairman*

MARK ~~O. HATFIELD,~~ Oregon
LOWELL P. WEICKER, Jr., Connecticut
PETE V. DOMENICI, New Mexico
MALCOLM WALLOP, Wyoming
JOHN W. WARNER, Virginia
FRANK H. MURKOWSKI, Alaska
DON NICKLES, Oklahoma
CHIC HECHT, Nevada
DANIEL J. EVANS, Washington

J. BENNETT JOHNSTON, Louisiana
DALE BUMPERS, Arkansas
WENDELL H. FORD, Kentucky
HOWARD M. METZENBAUM, Ohio
JOHN MELCHER, Montana
BILL BRADLEY, New Jersey
JEFF BINGAMAN, New Mexico
JOHN D. ROCKEFELLER IV, West Virginia

Frank M. Cushing, *Staff Director*
Gary G. Ellsworth, *Chief Counsel*
D. Michael Harvey, *Chief Counsel for the Minority*

Subcommittee on Energy Regulation and Conservation

DON NICKLES, Oklahoma, *Chairman*

MARK O. HATFIELD, Oregon
PETE V. DOMENICI, New Mexico
JOHN W. WARNER, Virginia
CHIC HECHT, Nevada
DANIEL J. EVANS, Washington

HOWARD M. METZENBAUM, Ohio
WENDELL H. FORD, Kentucky
BILL BRADLEY, New Jersey
JEFF BINGAMAN, New Mexico
JOHN D. ROCKEFELLER IV, West Virginia

James A. McClure and J. Bennett Johnston are Ex Officio Members of the Subcommittee
Howard Useem, *Professional Staff Member*

CONTENTS

STATEMENTS

Page

Bingaman, Hon. Jeff, a U.S. Senator from the State of New Mexico 5
Broun, E.C. Jr., executive vice president, Hughes Tool Co., on behalf of the Petroleum Equipment Suppliers Association 149
Bunn, Richard L., senior vice president, UGI Corp., and chairman, Associated Gas Distributors 324
Conklin, Danny, vice chairman, Natural Gas Supply Association 5
Davis, T.E., general manager, Natural Gas Department, Conoco, Inc 145
Dienstbier, Dan, executive vice president for gas pipeline operation, HNG/Internorth 261
Domenici, Hon. Pete V., a U.S. Senator from the State of New Mexico 157
Eck, Dr. Theodore R., chief economist, Amoco Corp 123
Elam, Jack, chairman, Process Gas Consumers Group 412
Evans, Hon. Daniel J., a U.S. Senator from the State of Washington 31
Ford, Hon. Wendell H., a U.S. Senator from the State of Kentucky 4
Gooch, Gordon, counsel, Petrochemical Energy Group 425
Hogan, Thomas E., president, Wheless Drilling Co., on behalf of the International Association of Drilling Contractors 147
Honeyman, Craig S., manager, economic development, Northwest Natural Gas Co 399
House, David W., on behalf of the Oklahoma Independent Petroleum Association 31
Jones, Vernon T., president, the Williams Companies 197
King, Peter J., Jr., vice chairman, Colorado Interstate Gas Co., and chairman, Interstate Natural Gas Association of America 175
Kirk, Randal M., general counsel, Leede Oil & Gas, Inc 445
Morris, Richard S., president, El Paso Natural Gas Co 216
Nickles, Hon. Don, a U.S. Senator from the State of Oklahoma 1
Ramsey, Joseph E., vice president, marketing, Tennessee Gas Transmission Co 248
Reif, Louis R., president and chief executive officer, National Fuel Gas Co., and chairman, American Gas Association 282
Russell, Donald G., vice president, production, Shell Oil Co 98
Smith, S. Kinnie, Jr., vice chairman, American Natural Resources Co 207
Stewart, Robert W., chairman, Primark Corp 385
Tell, William K., Jr., senior vice president, Texaco, Inc 48
Vlcek, Jan, counsel, Process Gas Consumers Group 410

FEDERAL ENERGY REGULATORY COMMISSION'S NATURAL GAS PIPELINE REGULATION

THURSDAY, SEPTEMBER 19, 1985

U.S. SENATE,
SUBCOMMITTEE ON ENERGY REGULATION
AND CONSERVATION,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:34 a.m., in room SD-366, Dirksen Senate Office Building, Hon. Don Nickles, presiding.

Present: Senators Nickles, Domenici, Warner, Hecht, Evans, Bumpers, Ford, and Bingaman.

Also present: Howard Useem, professional staff member; and Elizabeth Moler, counsel for the minority.

OPENING STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator NICKLES. Good morning. Today the subcommittee is holding a hearing dealing with natural gas to review the Federal Energy Regulatory Commission's notice of proposed rulemaking entitled "Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol."

The purpose of this oversight hearing is to explore the implications for producers, pipelines, distribution companies, and consumers of the NOPR and to assess its potential consequences for U.S. energy security. In the letter of invitation to the witnesses I asked that they provide the subcommittee with their views on the following issues. First, would the public interest be better served by retaining the existing regulatory system? Second, would the NOPR create a regulatory system that would be operationally workable and also legally sound? Third, would the NOPR create a regulatory system that would assure residential, commercial and industrial consumers a reliable long-term supply of natural gas at the lowest possible cost? And, fourth, what impact would the regulatory system the NOPR proposes to create have on exploration for new gas supplies and production from existing gas reserves?

Although I have reservations about several aspects of the NOPR, I am particularly concerned about its block billing provisions. They have potential for decimating domestic gas exploration and development. If that were to occur, this Nation's long-term gas supply would be jeopardized, gas shortages and price increases would reappear in the not-too-distant future, and this Nation would become more dependent on and vulnerable to insecure supplies of foreign energy.

Coming at a time when the entire petroleum industry is already reeling from the consequences of falling oil and gas prices and reduced demand, these proposed changes could jeopardize our domestic energy supply and put U.S. consumers back into the grips of the OPEC cartel. That would seriously harm U.S. energy security and in my opinion it would be bad energy policy.

One of my greatest concerns about block billing is what it may also do to the consumer in the long run. Although we are now experiencing a gas glut, the proposal has the potential for reversing our domestic abundance and returning the United States to gas shortages worse than what we experienced during the 1960's and 1970's.

Recall that during the winter of 1976-77 gas shortages in Midwestern States that shut down schools and businesses, throwing thousands out of work. False savings now at the expense of needed exploration for and development of new gas reserves can only lead to supply disruptions and major price increases down the road.

The block billing proposal would have a particularly pernicious impact on my State of Oklahoma. Analysis by Conoco concluded that the block billing proposal would penalize Oklahoma gas producers more than $800 million per year and it would cost the State of Oklahoma nearly $60 million per year in lost severence taxes. If this occurs, the impact on the Oklahoma economy would be significant and without saying our economy as well as the economy of other producing States are in difficulty, to say the least.

Altogether, producers located in some 30 States could lose many billions of dollars if the block billing proposal goes into effect. Block billing would also decimate the ranks of energy service companies who supply the energy industry with $33 billion worth of products and services. Thousands of people all over the United States would be thrown out of work if that should happen. I am sure that we will be hearing more about that today from our other witnesses.

I would like to note, however, that not all parts of the proposed regulatory changes may be detrimental to consumers and producers. If the Commission's gas transportation proposal works as intended, gas consumers will gain access to new supplies of gas that they might have otherwise been denied. That would also be good for producers who want to sell readily available supplies of gas that would otherwise be shut in as a result of the current regulatory morass.

So I am hopeful that today we will hear more from witnesses in the private sector that will help further establish the record. I am hopeful, too, that FERC will listen to the statements today and will take into account the statements by experts in the field of the real impact of what the NOPR will have on the industry. I think that needs to be heard.

I am sure that everybody testifying today has submitted their written comments to FERC, but I am hopeful that the Commission will be not only in attendance but they will be listening very attentively to the statements that are heard today, because, needless to say, we're talking about billions of dollars. We're talking about really the health of the natural gas industry and I think it's a most important issue that I hope will see some substantial changes, particularly, as I stated, in the block billing proposal.

Senator Bingaman, we are pleased that you are joining us today. You have mentioned your concern and your interest in this issue with me on past occasions, and I am pleased that you are joining us this morning. Do you have any statement?

Senator BINGAMAN. Well, I do, thank you. Mr. Chairman, thank you very much. I first have a statement that Senator Ford wanted to have included in the record, and if I could do that I would just insert that.

Senator NICKLES. Certainly.

[The prepared statement of Senator Ford follows:]

STATEMENT BY SENATOR WENDELL H. FORD

Subcommittee on Energy Regulation and Conservation

Hearing on FERC No. P.R. 85-1

September 19, 1985

Mr. Chairman, I want to thank you for holding this second day of hearings to explore the impact of the Federal Energy Regulatory Commission's Notice of Proposed Rulemaking on the natural gas industry and natural gas consumers.

The NOPR would restructure the industry, perhaps having an even greater impact than the NGPA itself. What troubles me is that such a radical change is being proposed by the regulatory agency. We in the Congress are the ones ultimately responsible for insuring that adequate supplies of gas are available at reasonable prices.

I am sure that those at FERC who drafted the NOPR, and I am told that it was conceived primarily by economists, were well intentioned, but often the world envisioned by theorists has little to do with the real world. In fact, almost all of the written and oral comments made to the FERC indicate little public support for the proposal in its current form.

I am greatly concerned that the Commission is rushing headlong toward issuing a policy that will be very disruptive to natural gas markets. For example, I know that some in the industry believe that the NOPR, as proposed, would worsen the take-or-pay situation, and believe it would adversely affect smaller local distribution companies and their customers. It is important that we in the Congress understand the issues involved, because if the Commission does issue a rule that is seriously misguided, it is those of us in congress who will be held accountable by the public.

I welcome the witnesses appearing before us today and I look forward to hearing their testimony.

STATEMENT OF HON. JEFF BINGAMAN, A U.S. SENATOR FROM THE STATE OF NEW MEXICO

Senator BINGAMAN. I wanted to just thank you for agreeing to hold these hearings. I understand that the proposed rulemaking is expected to go forward, but I do think there is a lot of concern in my State of New Mexico, where we're the fourth-largest producer of natural gas in the country, about part D of the rulemaking related to the billing procedure for purchased gas.

I hope that some of the testimony will focus on part D and clarify what the impact of that or the potential impact of such a rulemaking would be.

I would also be interested in the effect which this type of rule could have on State oil and gas conservation programs in the areas of protection of corelative rights and prevention of waste. I think that this is another issue that has not been adequately considered by the Commission and something that we should try to address this morning in the testimony.

Again, Mr. Chairman, I thank you for holding the hearing and I look forward to the testimony.

Senator NICKLES. Thank you very much. To all of our panelists—we have a distinguished group of panelists—we have a very big agenda today and we also have some legislative items that we're working on on the floor, so I have requested all of our panelists, if they could, to insert their statements and try and make your oral remarks within 5 minutes, if possible.

We'll start with Mr. Conklin and work our way down the table, and at the conclusion of the entire panel we will ask some questions at that time.

Mr. Conklin.

STATEMENT OF DANNY CONKLIN, VICE CHAIRMAN, NATURAL GAS SUPPLY ASSOCIATION

Mr. CONKLIN. Thank you, Mr. Chairman and members of the subcommittee. My name is Danny Conklin and I am appearing today before the subcommittee in my capacity as vice chairman of the Natural Gas Supply Association. NGSA is a trade association which represents the interests of integrated and independent natural gas production companies which produce 80 to 85 percent of the nation's natural gas.

By way of background, I am a petroleum geologist and a partner in Philcon Development Co., one of NGSA independent company members from Amarillo, TX. NGSA appreciates the opportunity to participate in this timely hearing on the Federal Energy Regulatory Commission's notice of proposed rulemaking, NOPR, issued late in May.

At the Commission's public hearings on the NOPR, substantial support was expressed in particular for part A of the NOPR, which provides new opportunities for nondiscriminatory access to transportation. The transportation proposals are designed to protect consumers by introducing competitive opportunities in a primarily monopolistic transmission industry, an industry which has increased its concentration through mergers of previously competing pipelines and an industry which has enjoyed substantial return on its investments while losing sales.

The take-or-pay proposal and block billing, on the other hand, were almost uniformly rejected by the producers, the interstate pipelines and the LDC's. My remarks this morning, Mr. Chairman, will concentrate on the NOPR's block billing proposal and in responding to the questions on the NOPR which you raised in your September 9 letter to the NGSA president, Mr. Bush.

Mr. Chairman, I will summarize my comments but would commend to your attention and that of the members of the subcommittee NGSA's more detailed filed comments to the Federal Energy Regulatory Commission on the notice of proposed rulemaking which were made part of the record of the subcommittee's July 11 meeting.

We believe the three-part block billing procedures, the provision to grant certain historical pipeline customers a new unilateral right to reduce firm contract demand, and the take-or-pay buyout proposal, will not achieve the Commission's stated goals or are beyond the Commission's authority.

FERC's proposals merely push existing distortions further down the marketing chain, resulting in a new system of price distortions and discrimination with a different allocation of economic grants and do so without any apparent social justification. Until the market distortions which currently exist and which result from prior regulatory and legislative policies are eliminated, the public interest will not be served.

This is a timely hearing not only because FERC action on the NOPR is expected soon but because of the recent release by the Energy Information Administration of 1984 preliminary natural gas reserve estimates. The EIA's estimates show the continuation of what is to producers an alarming trend, certainly to be exacerbated by the NOPR.

According to EIA's estimates, natural gas production once again outpaced the level of new gas discoveries. Even more troublesome, proved reserves of natural gas dropped to the lowest level in 9 years. Total proven reserves declined 3 trillion cubic feet. More critically, the level of total new gas discoveries in 1984 amounted to 13.5 trillion cubic feet, or only 79 percent of total 1984 production of just over 17 trillion.

While producers are optimistic about the potential of the Nation's domestic resource base, the long-term trend in the gas supply picture is hardly worth cheering about. One has just to look at the number of new discoveries and the rate at which annual production is replaced by new discoveries made that year. We have supplied the subcommittee members with a set of charts. In the interest of time, I would like to just discuss three or four of them.

Attachment 1 shows the decline in the Nation's ready inventory of gas over the past 15 years, with the latest EIA numbers added. Total domestic gas reserves available for production are now below a 10-year supply level.

Attachment 3 shows the level of drilling activity over time and the reserve additions each year. We have plotted total reserves added each year and the number of gas wells drilled each year. As a subset of the total wells we have added exploration wells. Obviously drilling activity has responded to current market conditions by dropping dramatically from the 1981–82 levels.

Reserve additions have also dropped. And, as I have just mentioned, the reserves added by each new well are dropping over time. So if consumption remains constant, as we think it will, and we want to replace the gas we use each year, then barring a major new find in the lower 48 States, which is less and less likely, producers have to drill at least the same number of wells and probably more each year just to stay even.

The point of these two charts which I have discussed is these substantial corrections are also already occurring at the supply end to bring supply and demand into balance under current policies. Certain provisions of the NOPR will not smooth this transition, nor will it eliminate the distortions and inequities that make this transition so painful. Rather, these provisions, particularly block billing, will increase the price distortions and the level of consumer price discrimination in the market.

If you will look at attachment 5, it illustrates the possibilities. It shows that the range in the current weighted average cost of gas among the 29 major interstate pipelines is $1.67/MMBtu. Obviously the current price system is already a highly distorted situation, but block billing will take the lowest block 1 price to $0.78/MMBtu, and the highest block 2 price to $4.36/MMBtu.

Thus, the potential difference between the highest and lowest-priced customers under block billing could increase from $1.67/MMBtu to $3.58/MMBtu. Moreover, the customer receiving the block 1 or 2 prices sees artificial pricing, encouraging overconsumption at one end and underconsumption at the other.

Undoubtedly such an artificial signal to conserve or use gas will have the wrong effect, but what the total impact will be, I don't know, nor do I think anyone else knows.

However, if block billing is introduced and block 1 gas, which is regulated at below-market prices, is made available only to certain customers, the price of all block 2 gas will probably fall to the price incurred by the pipeline holding the least-cost mix of block 2 gas supplies.

This will occur because in removing the moderating effect of averaging the block 2 prices with block 1 gas, which together produce a market price, block 2 will be subjected to market pressures which will result in a short-term overall price which is below a true market value. By market value I mean a price which will result over the long term in balancing supply and demand. Moreover, the variation in gas costs to consumers would still be greater under block billing than that resulting from the current rolled-in price mechanism.

The result to producers as a result of block billing will be to produce even less natural gas. Attachment 6 shows the potential effect of block billing on the number of gas wells drilled.

We believe that the translation of losses in capital, lower price expectations and losses in demand caused by block billing could cause an even more severe decline in drilling activity. The result could be that the additions to the Nation's proved reserves fall dramatically. Instead of continuing to replace our production each year, we may find ourselves quickly eliminating any surplus in supply, real or perceived, by replacing only 45 to 75 percent of our annaul production with new reserves.

Mr. Chairman, in response to one of the questions you have raised, let me show you an illustration of what block billing will mean to consumers.

Senator NICKLES. Mr. Conklin, could I interrupt you? I'm going to have to really keep the hearing going or I'm not going to make a lot of commitments. I know what you are getting ready to say and I'll ask you that in a question.

Mr. CONKLIN. Well, I think, you know, our points are, Mr. Chairman, that we are not pleased with block billing and if I were to summarize my statement and thank you for the opportunity to appear.

[The prepared statement of Mr. Conklin follows:]

TESTIMONY
OF
DANNY CONKLIN
FOR THE
NATURAL GAS SUPPLY ASSOCIATION
(NGSA)

BEFORE THE
U.S. SENATE
SUBCOMMITTEE ON ENERGY REGULATION & CONSERVATION
COMMITTEE ON ENERGY AND NATURAL RESOURCES
ON
THURSDAY, SEPTEMBER 19, 1985

GOOD MORNING, MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE. MY NAME IS DANNY CONKLIN AND I AM APPEARING TODAY BEFORE THE SUBCOMMITTEE IN MY CAPACITY AS VICE CHAIRMAN OF THE NATURAL GAS SUPPLY ASSOCIATION (NGSA). N-G-S-A IS A TRADE ORGANIZATION WHICH REPRESENTS THE INTERESTS OF INTEGRATED AND INDEPENDENT NATURAL GAS PRODUCTION COMPANIES WHICH PRODUCE 80 - 85 PERCENT OF THE NATION'S NATURAL GAS.

BY WAY OF BACKGROUND, I AM A PETROLEUM GEOLOGIST AND PARTNER IN PHILCON DEVELOPMENT COMPANY, ONE OF N-G-S-A'S INDEPENDENT COMPANY MEMBERS FROM AMARILLO, TEXAS.

N-G-S-A APPRECIATES THE OPPORTUNITY TO PARTICIPATE IN THIS TIMELY HEARING ON THE FEDERAL ENERGY REGULATORY COMMISSION'S (FERC) NOTICE OF PROPOSED RULEMAKING (NOPR) ISSUED LATE IN MAY. AT THE COMMISSION'S PUBLIC HEARINGS ON THE N-O-P-R, SUBSTANTIAL SUPPORT WAS EXPRESSED IN PARTICULAR FOR PART A OF THE N-O-P-R, WHICH PROVIDES NEW OPPORTUNITIES FOR NON-DISCRIMINATORY ACCESS TO TRANSPORTATION.

THE TRANSPORTATION PROPOSALS ARE DESIGNED TO PROTECT CONSUMERS BY INTRODUCING COMPETITIVE OPPORTUNITIES IN A PRIMARILY MONOPOLISTIC TRANSMISSION INDUSTRY -- AN INDUSTRY WHICH HAS INCREASED ITS CONCENTRATION THROUGH MERGERS OF PREVIOUSLY COMPETING PIPELINES AND AN INDUSTRY WHICH HAS ENJOYED SUBSTANTIAL RETURN ON ITS INVESTMENTS WHILE LOSING SALES.

THE TAKE-OR-PAY PROPOSAL AND BLOCK BILLING ON THE OTHER HAND WERE ALMOST UNIFORMLY REJECTED BY THE PRODUCERS, INTERSTATE PIPELINES AND L-D-C'S.

MY REMARKS THIS MORNING, MR. CHAIRMAN, WILL CONCENTRATE ON THE N-O-P-R'S BLOCK BILLING PROPOSAL AND IN RESPONDING TO THE QUESTIONS ON THE N-O-P-R WHICH YOU RAISED IN YOUR SEPTEMBER 9 LETTER TO N-G-S-A PRESIDENT, NICHOLAS J. BUSH.

MR. CHAIRMAN, I WILL SUMMARIZE MY COMMENTS BUT WOULD COMMEND TO YOUR ATTENTION AND THAT OF THE MEMBERS OF THE SUBCOMMITTEE N-G-S-A'S MORE DETAILED FILED COMMENTS TO THE FEDERAL ENERGY REGULATORY COMMISSION ON THE NOTICE OF PROPOSED RULEMAKING WHICH WERE MADE PART OF THE RECORD OF THE SUBCOMMITTEE'S JULY 11 HEARING.

WE BELIEVE THE THREE-PART BLOCK BILLING PROCEDURES, THE PROVISION TO GRANT CERTAIN HISTORICAL PIPELINE CUSTOMERS A NEW UNILATERAL RIGHT TO REDUCE FIRM CONTRACT DEMAND AND THE TAKE-OR-PAY BUYOUT PROPOSAL WILL NOT ACHIEVE THE COMMISSION'S STATED GOALS OR ARE BEYOND THE COMMISSION'S AUTHORITY.

F-E-R-C'S PROPOSALS MERELY PUSH EXISTING DISTORTIONS FURTHER DOWN THE MARKETING CHAIN, RESULTING IN A NEW SYSTEM OF PRICE DISTORTIONS AND DISCRIMINATION WITH A DIFFERENT ALLOCATION OF ECONOMIC RENTS AND DO SO WITHOUT ANY APPARENT SOCIAL JUSTIFICATION. UNTIL THE MARKET DISTORTIONS WHICH CURRENTLY EXIST AND WHICH RESULT FROM PRIOR REGULATORY AND LEGISLATIVE POLICIES ARE ELIMINATED, THE PUBLIC INTEREST WILL NOT BE SERVED.

MR. CHAIRMAN, THIS IS A TIMELY HEARING NOT ONLY BECAUSE F-E-R-C ACTION ON THE N-O-P-R IS EXPECTED SOON, BUT BECAUSE OF THE RECENT RELEASE BY THE ENERGY INFORMATION ADMINISTRATION (EIA) OF 1984 PRELIMINARY NATURAL GAS RESERVE ESTIMATES.

THE E-I-A'S ESTIMATES SHOW THE CONTINUATION OF WHAT IS TO PRODUCERS AN ALARMING TREND, CERTAINLY TO BE EXACERBATED BY THE N-O-P-R. ACCORDING TO E-I-A'S ESTIMATES, NATURAL GAS PRODUCTION ONCE AGAIN OUTPACED THE LEVEL OF NEW GAS DISCOVERIES.

EVEN MORE TROUBLESOME, PROVED RESERVES OF NATURAL GAS DROPPED TO THE LOWEST LEVEL IN NINE YEARS. TOTAL PROVEN RESERVES DECLINED 3 TRILLION CUBIC FEET. MORE CRITICALLY, THE LEVEL OF TOTAL NEW GAS DISCOVERIES IN 1984 AMOUNTED TO 13 AND A HALF TRILLION CUBIC FEET OR ONLY 79 PERCENT OF TOTAL 1984 PRODUCTION OF JUST OVER 17 TRILLION CUBIC FEET.

YOU MAY HEAR STATEMENTS TODAY THAT THE E-I-A ESTIMATES ARE SOMEHOW FURTHER EVIDENCE THAT THE U.S. SUPPLY PICTURE IS STRONG AND POSITIVE. WHILE PRODUCERS ARE OPTIMISTIC ABOUT THE POTENTIAL OF THE NATION'S DOMESTIC RESOURCE BASE, THE LONG-TERM TREND IN THE GAS SUPPLY PICTURE IS HARDLY WORTH CHEERING ABOUT. ONE HAS JUST TO LOOK AT THE NUMBER OF NEW DISCOVERIES AND THE RATE AT WHICH ANNUAL PRODUCTION IS REPLACED BY NEW DISCOVERIES MADE THAT YEAR.

WE HAVE SUPPLIED THE SUBCOMMITTEE MEMBERS WITH A SET OF CHARTS AND I WOULD LIKE TO DISCUSS THEM VERY BRIEFLY.

(ATTACHMENT #1)

ATTACHMENT #1 SHOWS THE DECLINE IN THE NATION'S READY INVENTORY OF GAS OVER THE PAST 15 YEARS. WITH THE LATEST E-I-A NUMBERS ADDED, TOTAL DOMESTIC GAS RESERVES AVAILABLE FOR PRODUCTION ARE NOW BELOW A 10-YEAR SUPPLY LEVEL.

(ATTACHMENT #2)

ATTACHMENT #2 REFLECTS THE PRODUCTIVITY OF THE GAS FINDING RATE, THAT IS, THE RESERVES ADDED BY EACH WELL. DISCOVERIES PER GAS WELL DRILLED HAVE BEEN DECLINING -- A NATURAL PHENOMENA SINCE THE MOST SHALLOW, LARGEST AND LEAST COSTLY RESERVES WERE DISCOVERED FIRST.

THE DROP OF TOTAL RESERVES IN RECENT YEARS MEANS THAT ONLY A FEW YEARS AGO WE WERE PRODUCING SUBSTANTIALLY MORE THAN WE WERE FINDING. FOR THE LAST COUPLE YEARS WE HAVE BARELY STAYED ABOUT EVEN. HERE'S WHAT IT TAKES TO STAY JUST EVEN.

(ATTACHMENT #3)

ATTACHMENT #3 SHOWS THE LEVEL OF DRILLING ACTIVITY OVER TIME AND THE RESERVE ADDITIONS EACH YEAR.

WE HAVE PLOTTED TOTAL RESERVES ADDED EACH YEAR AND THE NUMBER OF GAS WELLS DRILLED EACH YEAR. AS A SUBSET OF THE TOTAL WELLS DRILLED, WE HAVE ADDED EXPLORATORY WELLS.

OBVIOUSLY, DRILLING ACTIVITY HAS RESPONDED TO CURRENT MARKET CONDITIONS BY DROPPING DRAMATICALLY FROM THE 1981-1982 LEVELS. RESERVE ADDITIONS HAVE ALSO DROPPED, AND AS I JUST MENTIONED, THE RESERVES ADDED BY EACH NEW WELL ARE DROPPING OVER TIME.

SO IF CONSUMPTION REMAINS CONSTANT, AS WE THINK IT WILL, AND WE WANT TO REPLACE THE GAS WE USE EACH YEAR, THEN BARRING A MAJOR NEW FIND IN THE LOWER 48 STATES WHICH IS LESS AND LESS LIKELY, PRODUCERS HAVE TO DRILL AT LEAST THE SAME NUMBER OF WELLS AND PROBABLY MORE EACH YEAR JUST TO STAY EVEN.

(ATTACHMENT #4)

THE NEXT ATTACHMENT SHOWS THE LEVEL OF CAPITAL EXPENDITURES MADE EACH YEAR BY PRODUCERS TO DRILL THE NATION'S GAS WELLS SINCE THE NATURAL GAS POLICY ACT (NGPA) WAS PASSED.

TO GIVE YOU SOME COMPARISON, I'VE ALSO INCLUDED THE CAPITAL EXPENDITURES FOR CONSTRUCTION FOR THE GAS UTILITY INDUSTRY WHICH IS, AS YOU CAN SEE, SUBSTANTIALLY LESS.

THE DRILLING EXPENDITURES SHOWN ARE NOT, OF COURSE, THE TOTAL COST OF FINDING AND DEVELOPING GAS. THEY DO NOT INCLUDE ANY OF THE COSTS TO ACQUIRE LEASES OR CONDUCT SEISMIC WORK, WHICH IS THE PRELIMINARY EXPLORATION ACTIVITY. NOR DO THE FIGURES INCLUDE ANY ADMINISTRATIVE COSTS OR THE COSTS TO MAINTAIN PRODUCTION FROM A WELL AFTER IT IS DRILLED.

AT THE PEAK YEAR, THE INDUSTRY SPENT $18.7 BILLION TO DRILL 19,000 GAS WELLS. THE LEVEL OF DRILLING EXPENDITURES OBVIOUSLY HAS ALREADY DROPPED IN RESPONSE TO THE MAJOR CHANGES IN THE MARKET.

THE POINT OF ALL THIS IS THAT SUBSTANTIAL CORRECTIONS ARE ALREADY OCCURRING AT THE SUPPLY END TO BRING SUPPLY AND DEMAND IN BALANCE UNDER CURRENT POLICIES. CERTAIN PROVISIONS OF THE NOPR WILL NOT SMOOTH THIS TRANSITION NOR WILL IT ELIMINATE THE DISTORTIONS AND INEQUITIES THAT MAKE THIS TRANSITION SO PAINFUL. RATHER, THESE PROVISIONS -- PARTICULARLY BLOCK BILLING -- WILL INCREASE THE PRICE DISTORTIONS AND THE LEVEL OF CONSUMER PRICE DISCRIMINATION IN THE MARKET.

(ATTACHMENT #5)

ATTACHMENT #5 ILLUSTRATES THE POSSIBILITIES. IT SHOWS THAT THE RANGE IN THE CURRENT WEIGHTED AVERAGE COST OF GAS AMONG THE 29 MAJOR INTERSTATE PIPELINES IS $1.67/MMBTU. OBVIOUSLY, THE CURRENT PRICE SYSTEM IS ALREADY A HIGHLY DISTORTED SITUATION.

BUT BLOCK BILLING WILL TAKE THE LOWEST BLOCK 1 PRICE TO $0.78/MMBTU AND THE HIGHEST BLOCK 2 PRICE TO $4.36/MMBTU. THUS THE POTENTIAL DIFFERENCE BETWEEN THE HIGHEST AND LOWEST PRICED CUSTOMERS UNDER BLOCK BILLING COULD INCREASE FROM $1.67/MMBTU TO $3.58/MMBTU.

MOREOVER, THE CUSTOMER RECEIVING THE BLOCK 1 OR 2 PRICES, SEES ARTIFICIAL PRICES, ENCOURAGING OVER-CONSUMPTION AT ONE END AND UNDER-CONSUMPTION AT THE OTHER. UNDOUBTEDLY SUCH AN ARTIFICIAL SIGNAL TO CONSERVE OR USE GAS WILL HAVE THE WRONG EFFECT.

BUT WHAT THE TOTAL IMPACT WILL BE, I DON'T KNOW. NOR DO I THINK ANYONE DOES!

HOWEVER, IF BLOCK BILLING IS INTRODUCED AND BLOCK 1 GAS WHICH IS REGULATED AT BELOW MARKET PRICES IS MADE AVAILABLE ONLY TO CERTAIN CUSTOMERS, THE PRICE OF ALL BLOCK 2 GAS WILL PROBABLY FALL TO THE PRICE INCURRED BY THE PIPELINE HOLDING THE LEAST COST MIX OF BLOCK 2 GAS SUPPLIES. THIS WILL OCCUR BECAUSE, IN REMOVING THE MODERATING EFFECT OF AVERAGING THE BLOCK 2 PRICES WITH BLOCK 1 GAS WHICH TOGETHER PRODUCE A MARKET PRICE, BLOCK 2 WILL BE SUBJECTED TO MARKET PRESSURES WHICH WILL RESULT IN A SHORT-TERM OVERALL PRICE WHICH IS BELOW A TRUE MARKET VALUE. BY MARKET VALUE, I MEAN A PRICE WHICH WILL RESULT OVER THE LONG TERM IN BALANCING SUPPLY AND DEMAND. MOREOVER, THE VARIATION IN GAS COSTS TO CUSTOMERS WOULD STILL BE GREATER UNDER BLOCK BILLING THAN THAT RESULTING FROM THE CURRENT ROLLED-IN PRICE MECHANISM.

(ATTACHMENT #6)

THE MARKET SIGNAL TO PRODUCERS AS A RESULT OF BLOCK BILLING WILL BE TO PRODUCE EVEN LESS NATURAL GAS. ATTACHMENT #6 SHOWS THE POTENTIAL EFFECT OF BLOCK BILLING ON THE NUMBER OF GAS WELLS DRILLED.

WE BELIEVE THAT THE TRANSLATION OF LOSSES IN CAPITAL, LOWER PRICE EXPECTATIONS AND LOSSES IN DEMAND CAUSED BY BLOCK BILLING COULD CAUSE AN EVEN MORE SEVERE DECLINE IN DRILLING ACTIVITY. THE RESULT COULD BE THAT THE ADDITIONS TO THE NATION'S PROVED RESERVES FALL DRAMATICALLY.

INSTEAD OF CONTINUING TO REPLACE OUR PRODUCTION EACH YEAR WE MAY FIND OURSELVES QUICKLY ELIMINATING ANY SURPLUS IN SUPPLY -- REAL OR PERCEIVED -- BY REPLACING ONLY 45 TO 75 PERCENT OF OUR ANNUAL PRODUCTION WITH NEW RESERVES.

(ATTACHMENT #7)

MR. CHAIRMAN, IN RESPONSE TO ONE OF THE QUESTIONS YOU HAVE RAISED, LET ME SHOW YOU AN ILLUSTRATION OF WHAT BLOCK BILLING WILL MEAN TO CONSUMERS.

ATTACHMENT #7 IS BASED ON A SURVEY OF PURCHASED GAS ADJUSTMENT FILINGS AS OF JUNE 1, 1985 FOR 25 MAJOR INTERSTATE PIPELINES. IT SHOWS THE POTENTIAL DISCRIMINATION THAT MAY OCCUR AMONG CONSUMERS WITHIN REGIONS AND AMONG CONSUMERS OF DIFFERENT REGIONS OF THE COUNTRY. WITHIN EACH REGIONAL SECTION ON THE LEFT IS THE CURRENT WACOG RANGE; ON THE RIGHT IS THE PROJECTED PRICE MIX UNDER BLOCK BILLING.

IN THE EAST SOUTH CENTRAL REGION WHICH INCLUDES THE STATES OF ALABAMA, KENTUCKY, MISSISSIPPI AND TENNESSEE, FOR EXAMPLE, CONSUMERS NOW SHARE IN A WEIGHTED AVERAGE GAS COST WITH A DIFFERENCE OF 38 CENTS. UNDER THE BLOCK BILLING SCHEME, HOWEVER, CONSUMERS IN THAT REGION WOULD CONFRONT A MIX OF PRICES VARYING FROM 78 CENTS TO $4.36, A DIFFERENCE OF $3.58.

MOREOVER, ANY BENEFITS FROM THIS NEW MIX WOULD ACCRUE ONLY TO THOSE CONSUMERS FORTUNATE ENOUGH TO BE SERVED BY A PIPELINE WHICH HAS PLENTIFUL SUPPLIES OF BLOCK 1 GAS. THESE BENEFITS WOULD OCCUR, HOWEVER, AT THE EXPENSE OF OTHER CONSUMERS IN THE REGION WHO HAVE NOT BEEN GRANTED AN ENTITLEMENT TO OLD GAS SUPPLIES BY THE F-E-R-C.

IN CLOSING, MR. CHAIRMAN I WOULD JUST NOTE THAT N-G-S-A BELIEVES THAT THE F-E-R-C AND CONGRESS HAVE ASSERTED IN THE PAST THAT A PRIMARY CONCERN IS TO ASSURE THAT DOMESTIC SUPPLIES OF NATURAL GAS ARE CONTINUALLY DEVELOPED AND MAINTAINED AT A RATE ADEQUATE TO KEEP PACE WITH DEMAND. WITH THE ISSUANCE OF THE RECENT N-O-P-R, F-E-R-C IS FOCUSING SOLELY ON SHORT-TERM CONSUMER PRICES FOR NATURAL GAS, AT THE EXPENSE OF ADEQUATE FUTURE DOMESTIC GAS SUPPLIES. THE NEW DISTORTIONS THAT WILL RESULT FROM THE N-O-P-R WILL SET UP A NEW ORDER OF PRICE DISCRIMINATION WHICH I DON'T BELIEVE WAS ENVISIONED BY THE ARCHITECTS OF THE N-G-P-A.

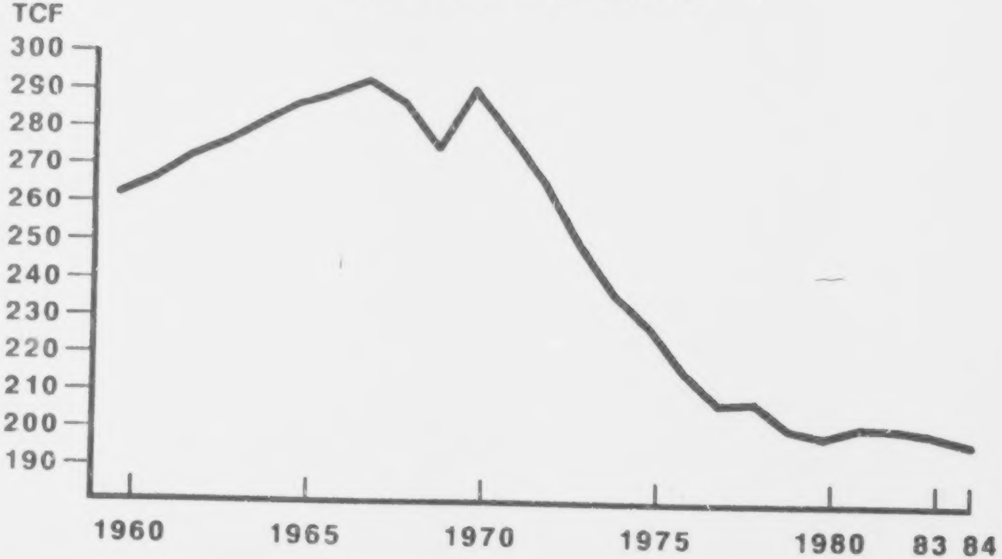
N-G-S-A BELIEVES THAT THE DISTORTIONAL EFFECTS OF THE "CUSHION" OF OLD GAS SUPPLIES CAN ONLY BE REMOVED BY THE ELIMINATION OF WELLHEAD PRICE CONTROLS. F-E-R-C CAN REDUCE THE CURRENT LEVEL OF DISTORTIONS BY ALLOWING PRE-GRANTED ABANDONMENT WHICH WOULD PERMIT PRODUCERS TO ABANDON ALL JURISDICTIONAL GAS SALES AT THE END OF THE CONTRACT TERM OR WHEN THE CONTRACT IS TERMINATED AND BY EXERCISING ITS AUTHORITY TO ESTABLISH JUST AND REASONABLE RATES ACROSS THE BOARD, PURSUANT TO THE AUTHORITY ALREADY GRANTED UNDER THE N-G-P-A.

SUCH ACTION BY THE F-E-R-C WOULD ENCOURAGE A MORE OPTIMUM DEVELOPMENT OF LEAST COST GAS IN A COMPETITIVE ATMOSPHERE. CONSUMERS WOULD BE PROVIDED NATURAL GAS AT THE LOWEST REASONABLE RATES CONSISTENT WITH RELIABLE LONG-TERM SUPPLIES. IT WOULD ALSO ELIMINATE MARKET DISTORTIONS WHICH HAVE RESULTED FROM PRIOR REGULATORY POLICIES. LEGISLATION SUCH AS S.1302, WHICH YOU AUTHORED, MR. CHAIRMAN, COULD REPRESENT AN APPROPRIATE VEHICLE FOR ACCOMPLISHING THIS OBJECTIVE.

THANK YOU FOR THIS OPPORTUNITY TO APPEAR AND PRESENT THE VIEWS OF THE NATURAL GAS SUPPLY ASSOCIATION. I WOULD BE PLEASED TO ANSWER ANY QUESTIONS WHICH YOU MAY HAVE.

ATTACHMENT #1

PROVED RESERVES OF NATURAL GAS

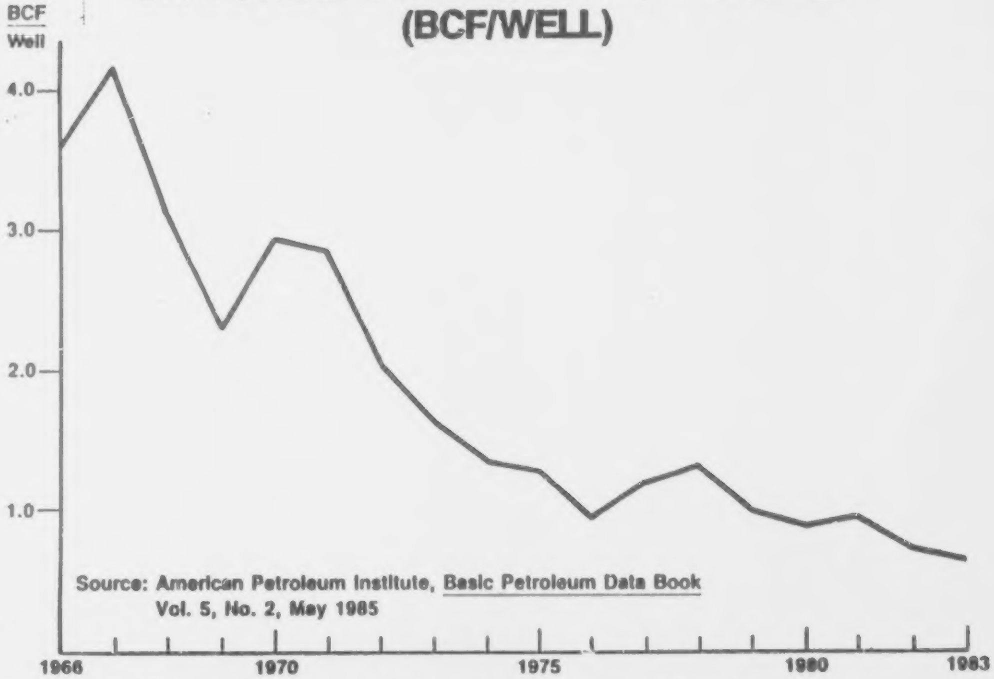


Sources: American Gas Association, Energy Information Administration

Natural Gas Supply Association

ATTACHMENT #2

DISCOVERIES PER GAS WELL DRILLED*
(BCF/WELL)



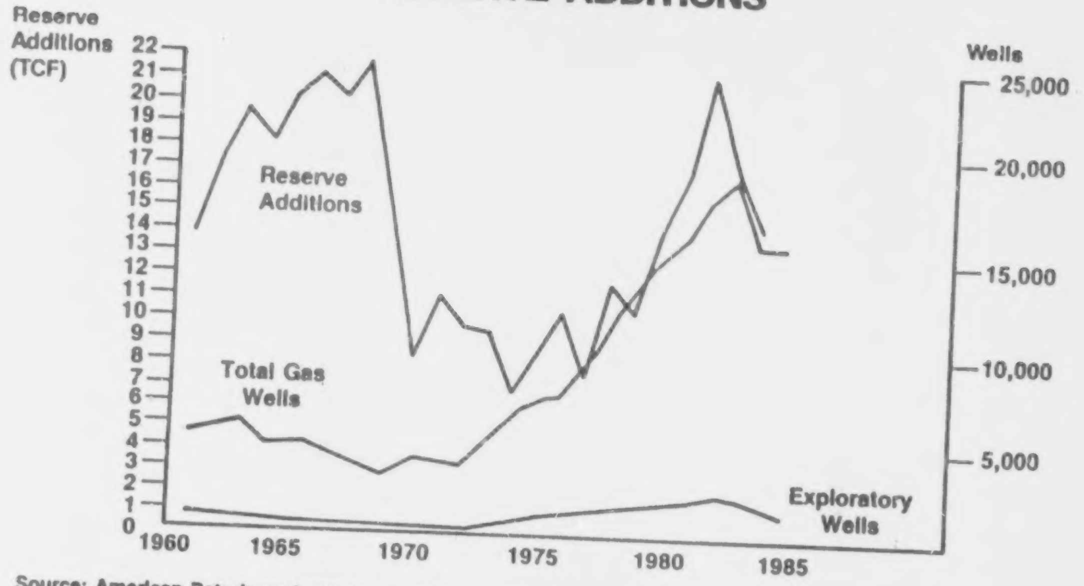
Source: American Petroleum Institute, Basic Petroleum Data Book
Vol. 5, No. 2, May 1985

*New Gas Discoveries and Extensions, Excludes Revisions and Adjustments

NATURAL GAS SUPPLY ASSOCIATION

ATTACHMENT #3

DRILLING ACTIVITY AND RESERVE ADDITIONS

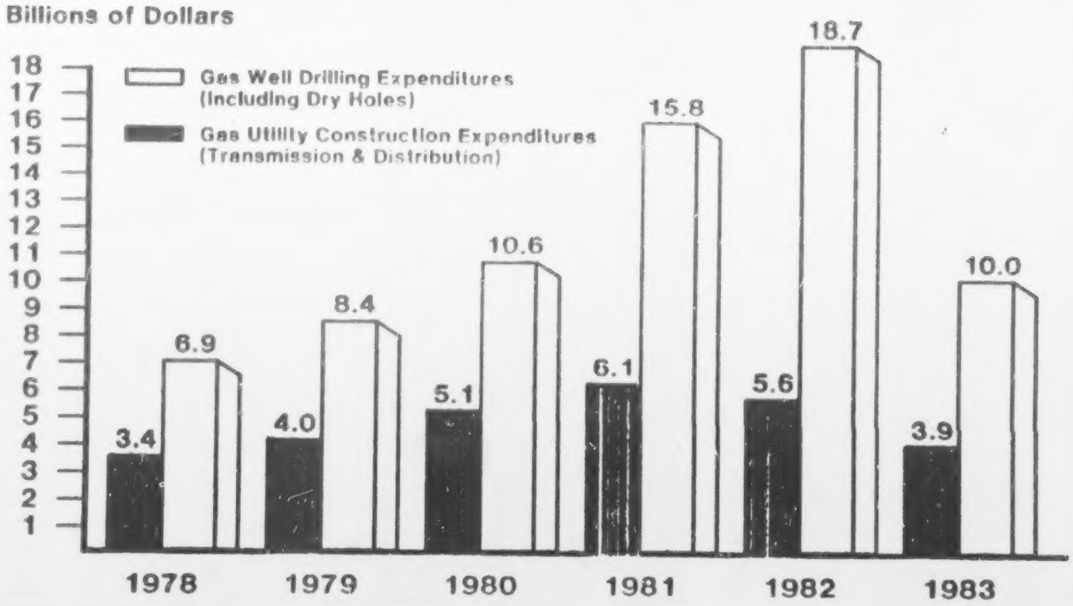


Source: American Petroleum Institute, Basic Petroleum Data Book Vol. 5, No. 2, May 1985.

NATURAL GAS SUPPLY ASSOCIATION

Attachment #4

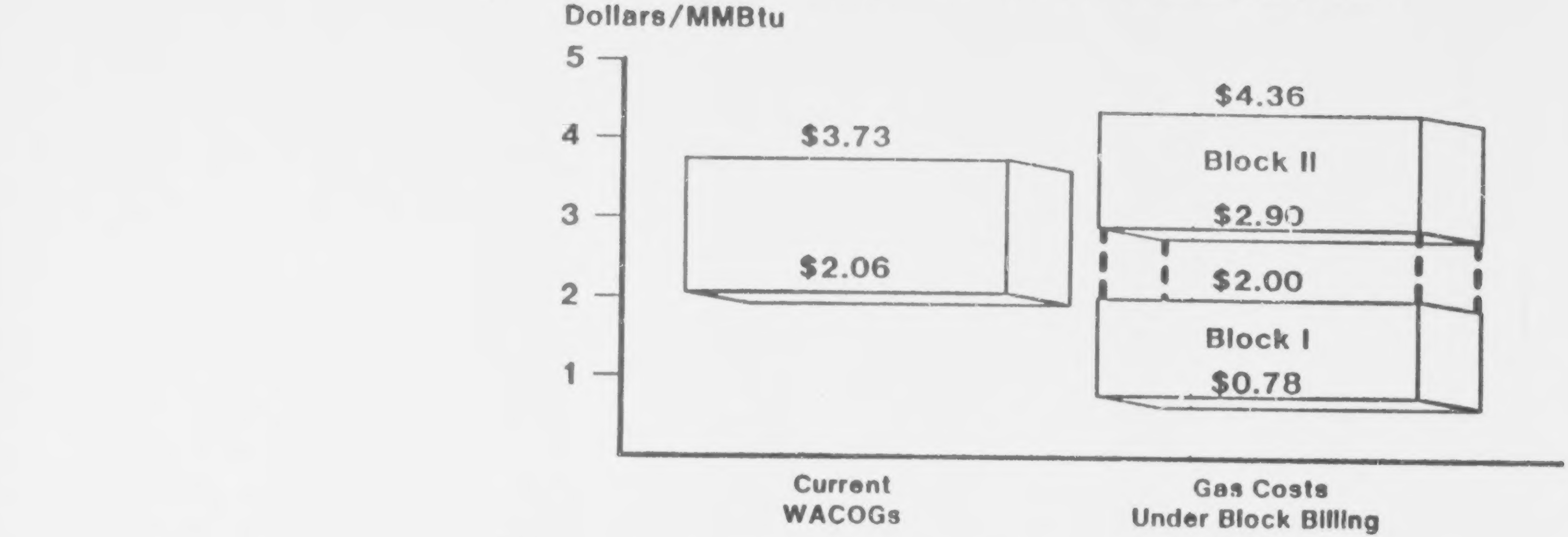
COMPARISON OF CAPITAL EXPENDITURES



Natural Gas Supply Association

Attachment #5

PURCHASE GAS COSTS*
EFFECT OF BLOCK BILLING

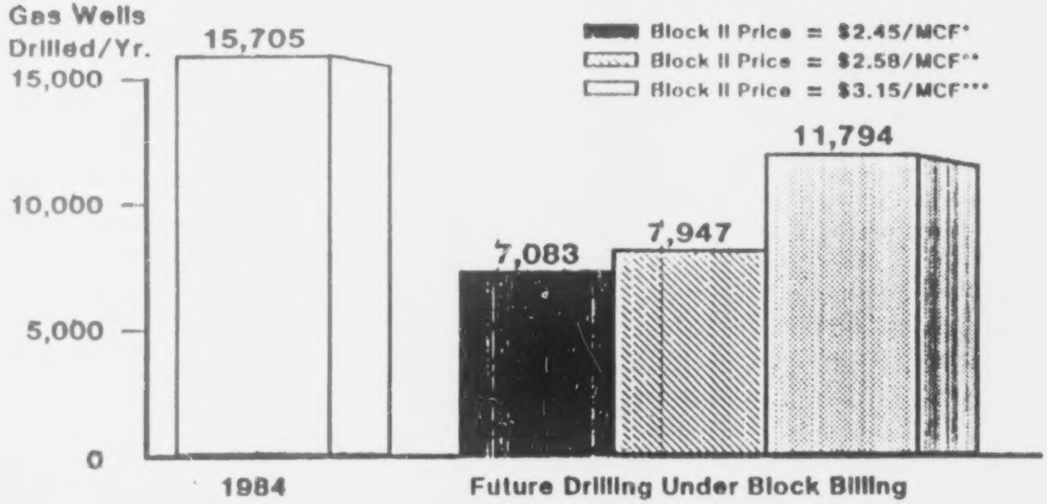


*29 Interstate Pipelines: Source: Purchase Gas Adjustment Filings. June 1, 1985.

Natural Gas Supply Association

Attachment #6

POTENTIAL EFFECTS OF BLOCK BILLING ON DRILLING



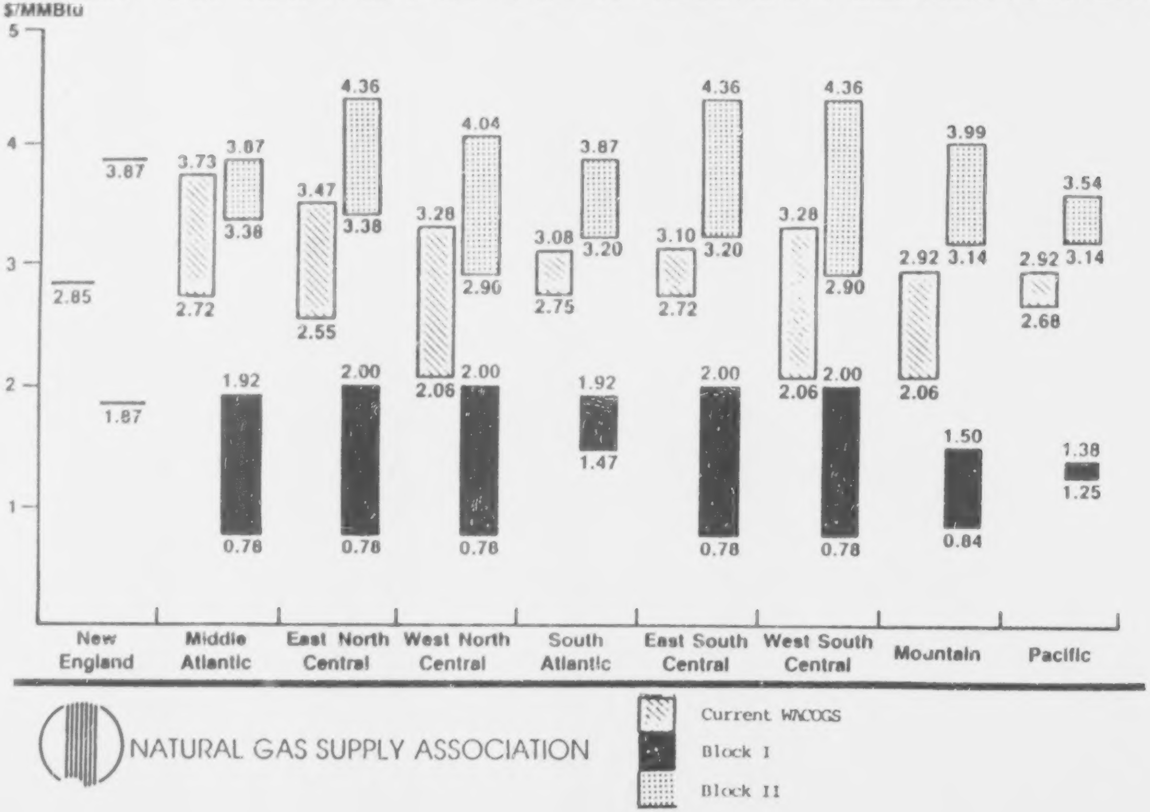
*Rocky Mountain Spot Price
**Texas & Gulf Coast Spot Price
***Appalachian Spot Price

Natural Gas Intelligence 6/17/85

Natural Gas Supply Association

Attachment #7

PURCHASE GAS COSTS
CURRENT WACOGs AND BLOCK BILLING BY CENSUS REGION



NATURAL GAS SUPPLY ASSOCIATION

Senator NICKLES. Thank you, Mr. Conklin.

Senator Evans, do you have any comments, opening comments?

Senator EVANS. Mr. Chairman, are you going to wait until the panel is finished before you ask the questions?

Senator NICKLES. Yes.

STATEMENT OF HON. DANIEL J. EVANS, A U.S. SENATOR FROM THE STATE OF WASHINGTON

Senator EVANS. Let me just very briefly, because I know you have many, many people waiting to testify, indicate that I don't pretend to know all of the nuances of the natural gas industry. I am here to find out a little bit more. My concerns, and they will probably be expressed by what questions I have, are the results of these proposals on small residential consumers, on large industrial customers, on the health of the local gas distribution systems, on the health of our pipeline transmitters and on the health of the natural gas industry as a whole.

And those all interrelate and it's the interrelationship and the equity in those interrelationships that I'll be interested in.

Senator NICKLES. Thank you.

Senator Domenici, did you have any opening comments?

Senator DOMENICI. I did, but, Mr. Chairman, what I'm going to do now, other than thank you for the hearing, is to wait until I hear a little more testimony. I have to leave around 10:30, so at some point I may want to make some set of remarks, but for now let me just accommodate and listen.

Senator NICKLES. Senator Hecht, did you have any opening comments?

Senator HECHT. No, Mr. Chairman.

Senator NICKLES. Senator Warner.

Senator WARNER. No. I'll have questions for the panel later.

Senator NICKLES. Thank you.

Mr. House, we do have a time clock and to accommodate 20-some-odd witnesses I think the yellow light comes on when there is 1 minute left and then the red light. We're not going to gavel anybody down, but we would appreciate it if you could kind of try and keep your remarks within the 5 minutes.

Mr. House.

STATEMENT OF DAVID W. HOUSE, ON BEHALF OF THE OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION

Mr. HOUSE. Good morning. My name is David House and I am speaking today on behalf of the Oklahoma Independent Petroleum Association. As many of you know, OIPA's 1,500-plus members are independent oil and gas producers who are operating primarily in the State of Oklahoma.

The written comments I have submitted in conjunction with testimony today discuss in more detail OIPA's primary concern with the FERC's proposed rulemaking. I would like to focus today on the specific issues raised by the subcommittee.

We believe the public interest would be best served by changing certain parts of the current regulatory system to provide for nondiscriminatory access to natural gas transmission, transportation for any shipper, and by allowing interstate pipelines more flexibility to respond timely and realistically to market changes.

In the last 2 to 3 years, the market has worked to reduce wellhead prices in response to competition in the end use markets. Producers would like to compete in these markets, but sometimes do not have access to economically priced transportation of their gas from wellhead to market. Under the existing regulatory structure a pipeline company can refuse to transport gas or it can charge rates for the service which are uneconomic because they include costs wholly unrelated to the services being performed.

Access to such transportation is the simplest, most effective means of letting market forces work and to increase competition and efficiency in this vital industry. The safe harbor presumption or prudence rules suggested by the FERC for one-time take-or-pay buyouts from interstate pipelines are too restrictive to allow pipelines to offer producers sufficient incentive to give up valid, valuable contract rights.

Rather than limiting the amounts of such payments to be an important part of the presumption, the FERC should allow pipelines to negotiate buyouts that are tailored to fit particular transactions, with a presumption of prudence subject to rebuttal in pipeline rate cases and allow the payments to be amortized over reasonable periods of time, as dictated in the situation.

The FERC's proposed block pricing rules are too extreme, in our view, and are contrary to the public interest. The current regulatory system of rolled-in pricing of pipeline sales has allowed pricing to be transmitted among market participants and has created an efficiency industry. The proposed block pricing rates defeat some of these objectives. My written comments discuss in detail why the block pricing rate proposal that will create, in our view, more economic distortion than it corrects.

The most important, we believe, is that the FERC would allow existing pipeline sales to customers to satisfy requirements first from gas, the average cost of which is significantly below market value. These major consumers of gas would not receive accurate market signals and would pass the same inaccurate signals along to their customers. The current regulatory system of roll-in pricing certainly communicates more accurately the current market value of gas.

The NOPR and the proposed rules include very little information regarding how the rule is to be implemented. For example, it is unclear how the FERC would determine what capacity is available on a pipeline for nondiscriminatory transportation.

We perceive block pricing would interfere also with the State regulation of conservation and corelative rights. We would anticipate several years of judicial review could be required to sort out State rights in these issues. Therefore, it is very difficult for us to meaningfully understand the workability or the legality of the proposed rules until they become final.

Additionally, let me say that the NOPR does not create a regulatory system that ensures reliable, long-term, low-cost supplies of gas. The market is currently operating to force wellhead prices lower. OIPA believes that the incorrect signals block pricing could send to the producing industry would result eventually in a considerable gap in time between the increase in market prices and the deliverability of new supplies.

OIPA believes that a free market in which all participants are provided equal opportunity to compete via the transportation vehicles necessary in this industry will eventually and quickly more than likely resolve the market imbalance. Whatever action FERC or Congress may take, it should remove, not create, regulatory impediments to competition.

I don't think we need to be reminded that it was the Federal regulation of wellhead prices and restrictions on the market participants to respond to market conditions that brought us the shortages of the early 1970's. OIPA urges Federal regulators to remember the lessons of history and when wellhead prices begin to increase again avoid the temptation to reimpose wellhead prices and allow the pendulum to swing again.

Thank you for your invitation today.

[The prepared statement of Mr. House follows:]

UNITED STATES OF AMERICA

BEFORE THE

SENATE SUBCOMMITTEE ON ENERGY REGULATION & CONSERVATION

COMMENTS OF THE OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION ON THE NOTICE OF PROPOSED RULEMAKING ISSUED BY THE FEDERAL ENERGY REGULATORY COMMISSION IN FERC DOCKET NO. RM85-1-000

David W. House

September 19, 1985

COMMENTS OF THE OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION

Upon invitation by Senator Don Nickles, the Oklahoma Independent Petroleum Association ("OIPA") hereby submits comments on the Notice of Proposed Rulemaking ("NOPR") issued by the Federal Energy Regulatory Commission ("FERC") on May 30, 1985.

I.

INTRODUCTION AND OVERVIEW

OIPA supports the development of regulations that would allow competition to operate to the maximum extent possible in the natural gas industry. However, OIPA would point out that, even without the comprehensive regulatory changes proposed by the FERC, market forces have operated to lower wellhead prices of natural gas in response to competitive forces in end-use markets. Providing for non-discriminatory access to natural gas transportation for all shippers would substantially enhance competition. However, such fundamental regulatory changes as the elimination of rolled-in pricing of low-cost gas supplies are unnecessary to allow accurate price signals to be communicated in the marketplace and to allow market participants to respond economically and competitively to these signals.

The following discussion summarizes briefly OIPA's major concerns with the FERC's proposed rules. The discussion is divided into the following subject areas: (i) transportation, (ii) optional expedited certificates, (iii) take-or-pay, (iv) adjustment of service agreements and obligations, and (v) billing mechanism for old gas supply.

II.

TRANSPORTATION

OIPA firmly believes that the simplest and most effective means of facilitating the operation of competitive forces already at work in the industry is to make economically viable transportation services available on a non-discriminatory basis to all potential shippers of natural gas. Accordingly, OIPA supports the FERC's proposed rules that would:

- Require any natural gas company that holds itself out as a transporter to provide firm transportation of any gas for any end use on a non-discriminatory basis to any shipper willing to pay the applicable filed rate;

- Condition NGPA Section 311(a) transportation and blanket certificate transportation on the establishment of an unbundled, volumetric, mileage- or zone-differentiated "band" of rates stated in tariffs filed at the FERC;

- Provide pipelines with incentives to transport gas on behalf of others by requiring that transportation rates be established on the basis of representative revenues or volumes; and

- Eliminate the two-year limitation and system supply requirement for NGPA Section 311(a) transportation.

OIPA, however, has serious concerns about certain of the FERC's proposed transportation regulations. First, unlike transportation service performed on behalf of interstate pipelines, intrastate pipelines and LDCs under NGPA Section 311, prior approval would still be required under the proposed blanket certificate for transportation service performed on behalf of "other" shippers for periods in excess of 120 days. As a general rule, these shippers would have to submit to the uncertainty and possibility of delay or interruption of self-implementing service inherent in the FERC's prior notice procedures. The FERC, however, advances no rationale for discriminating against such other shippers by limiting the term of the self-implementing transportation available to them, and there is none. OIPA submits that non-discriminatory blanket certificate transportation should be available to any shipper on a self-implementing basis for an unlimited term.

Second, in view of the numerous categories of firm pipeline sales and transportation services apparently contemplated by the FERC's proposed regulations, OIPA is uncertain as to just how "firm" the self-implementing, non-discriminatory transportation service would be under the FERC's proposed rules. OIPA favors regulatory policy that guarantees access to as much pipeline capacity as possible for such transportation.

OIPA thus has proposed that the FERC establish two classes of firm service. The first class would be comprised of a pipeline's "existing" firm sales and transportation service -- i.e., firm service authorized under Natural Gas Act ("NGA") Section 7(c) certificates issued before the effective date of the proposed rules. The second class of firm service would be comprised of "new" sales and transportation service -- i.e., all new, firm service not authorized under NGA Section 7(c) certificates as of the effective date of the proposed regulations, or new or increased service for existing customers. To the extent that sufficient firm capacity were not available to satisfy all requested new firm sales and transportation service for a particular time period or segment of the pipeline's system, then the available firm capacity would be prorated on a current tenders basis among all volumes tendered for new firm service.

In this way, an interstate pipeline's existing firm customers would continue to receive the services for which they contracted prior to the effective date of the proposed rules. In addition, new sales and transportation customers would have equal access to the pipeline's remaining capacity available for firm service, and this capacity would increase as the contracts underlying existing NGA Section 7(c) certificated service expired.

Under OIPA's proposal, all firm service would require the payment of a demand charge or similar "capacity reservation fee." OIPA submits that this fee should be the same for all firm service, *i.e.*, equal charge for equal quality of service. The factors affecting the determination of this firm service demand charge or reservation fee are likely to vary from pipeline to pipeline, and therefore should be determined in the context of an individual pipeline's rate case.

III.

OPTIONAL EXPEDITED CERTIFICATE

The FERC's proposed rules would create an expedited certification process that would be available for new and expanded services (including transportation and sales), and the construction of facilities requisite thereto. OIPA supports the optional expedited certificate program, *provided that* the FERC clarifies that the program is available to *all* market participants, not just to interstate pipelines. OIPA opposes regulations that would give pipelines an undue advantage over other market participants in the construction and operation of facilities that provide market access.

IV.

TAKE-OR-PAY

OIPA supports in principle the FERC's efforts to address the problems faced by interstate pipelines in meeting their contractual obligations to producers under current market conditions. The FERC's approach is consistent with the OIPA's view that any "problems" that may be created for pipelines by gas purchase contracts in the context of current market conditions must be approached by contract negotiation, not contract abrogation. OIPA, however, submits that the proposed regulations according a limited "safe harbor" presumption of prudence to interstate pipelines' lump sum payments made to extinguish take-or-pay obligations under certain gas supply contracts do not provide a meaningful or realistic approach to these problems.

A take-or-pay provision is one of many negotiated terms in a contract; a producer may have acceded to a pipeline's demands with respect to several terms of a sale, in return for the particular take-or-pay assurance promised by the pipeline. This assurance is an essential part of the economic criteria relied upon by producers to recover their capital expenditures, and to meet the costs necessary to maintain production and to provide incentive for additional exploration and products efforts. OIPA would also point out that Congress, by passing the NGPA, effectively told producers to find and produce natural gas as quickly and in as great amounts as possible. Producers did just that, in reliance on the economic rewards promised by the pipeline purchasers and allowed by the NGPA.

Understandably, producers are not willing to surrender the benefits of their bargains for little or no value, simply because the market has changed. Further, producers do not want to be hamstrung by unfavorable contracts in future periods of rising demand and increasing prices. The FERC's proposed rules, however, would appear to require pipelines somehow to negotiate such concessions with producers in order for take-or-pay "buy-outs" to qualify for the safe harbor presumption of prudence.

OIPA has proposed, instead, that the FERC give the pipelines as much negotiating flexibility as possible. OIPA further proposes that the FERC accord a presumption of prudence to all payments made to first sellers as consideration for their amending or waiving take-or-pay or similar minimum payment provisions in any agreement for the first sale of natural gas, subject to challenge in individual pipeline rate cases. OIPA also submits that the five-year amortization period for lump-sum payment proposed by the FERC may be longer than necessary for some pipelines and shorter than necessary for others to minimize rate impact. Accordingly, OIPA has suggested to the FERC that the appropriate amortization period should be established on an individual pipeline basis.

V.

ADJUSTMENT OF SERVICE AGREEMENTS AND OBLIGATIONS

OIPA opposes the FERC's proposal to allow interstate pipelines' existing sales customers unilaterally to reduce their contract demands for firm sales service, thus abrogating their contracts with the pipelines. As with its members' own contracts with pipeline companies, OIPA cannot advocate regulatory policy that results in contract abrogation.

OIPA submits that pipelines and their customers should be allowed to negotiate adjustments of service agreements and service obligations. If both parties agreed to a reduction in service, or agreed to convert firm sales service to firm transportation service, the FERC should provide the necessary authorizations for modification of existing service obligations, including pregranted abandonment, where applicable. In this way, the FERC would provide pipelines and their sales customers with the flexibility to adjust their contractual obligations in a mutually beneficial manner, on terms consistent with the conditions of a particular transaction, rather than condoning unilateral contract abrogation by pipeline customers.

VI.

BILLING PROCEDURES FOR OLD GAS SUPPLIES

Finally, OIPA opposes the FERC's proposal to eliminate rolled-in pricing of interstate pipelines' old gas supply. OIPA submits that the FERC's proposed block rate structure is a radical departure from traditional regulatory policies which is not needed to level the competitive playing field for interstate pipelines. Moreover, the proposal would largely defeat the primary purpose of the proposed regulations, i.e., to foster competition and greater efficiency in the natural gas industry.

OIPA submits that the assumptions underlying the FERC's block rate proposal are false. First, the FERC suggests that segregating old gas costs into one block available only to existing pipeline customers will force pipelines to stop offering above-market clearing prices for new gas, reasoning that they cannot roll in or average new gas purchase costs with the below-market regulated gas costs in the rates to their customers. This suggestion assumes that pipelines are buying new gas at above-market prices. However, as a matter of fact, if pipelines are contracting to buy additional gas supplies at all, they are not offering above-market prices, regardless of how much old or "cushion" gas they have. Accordingly, the elimination of rolled-in pricing of old gas will have no effect whatsoever on pipelines' purchasing patterns.

Second, the FERC cites no authority for its assumption that Congress "apparently intended" pipeline existing sales customers to benefit from the economic rents associated with old gas ceiling prices. That assumption, in fact, appears unsupportable in view of the complex program of incremental pricing of gas supplies prescribed by Congress in Title II of the NGPA. OIPA has been unable to find any support in Title II or its legislative history for the proposition that Congress intended existing sales customers alone to benefit from low, old gas prices.

Third, the FERC's proposal to make low-cost gas supplies available only to pipelines' existing sales customers magnifies any competitive advantage interstate pipelines with significant low-cost gas supplies may have over other marketers. These pipelines are virtually certain to retain their existing sales customers at full contract volumes by virtue of rates unreflective of market forces, thereby effectively precluding competition with other marketers for sales to this significant class of purchasers.

Fourth, it seems apparent to OIPA that the FERC's proposal to segregate old gas purchase costs into one block available only to pipelines' existing sales customers would utterly defeat the FERC's attempts to establish regulations that would allow the transmission of accurate price signals between the producing and consuming market segments. OIPA would point out the obvious, that making low-cost gas supplies available to only one class of customers would distort price signals to these customers to a far greater degree than the current practice of rolled-in pricing. The weighted average cost of all gas supplies, of course, is substantially more indicative of the market price of gas than the weighted average cost of old gas. Moreover, customers arbitrarily awarded a disproportionate share of old gas would be given an unfair competitive advantage over their competitors, in that below market energy supplies would be available to these customers, but not to their competitors. The existing customer thus would achieve a measure of profitability by virtue of federal regulatory fiat, not by virtue of more efficient or economic operation.

Finally, with no explanation of how Block 1 and Block 2 gas would be purchased in relation to one another, it appears likely that the FERC's block rate proposal would result in a collision with state regulation of natural gas production, to the extent the proposed rules resulted in pipeline purchasing practices contrary to state production laws. For example, the taking of gas by interstate pipelines based on price considerations may be inconsistent with state conservation laws and with the protection of correlative rights.

The FERC's proposed three-part rate proposal thus not only would fail to alter pipeline purchasing practices, it also would result in severe new economic distortions in the industry and create potential conflict with state regulation of natural gas production.

VII.

CONCLUSION

The FERC is to be commended for its efforts to deal with the regulatory barriers that inhibit competition in the natural gas industry and prevent industry participants from responding to rational economic signals. The OIPA believes, however, that certain of the FERC's proposals to make gas markets more competitive either do not go far enough or go farther than necessary to achieve a more competitive and efficient industry.

Moreover, unless the FERC's final rules are integrated with the regulation of natural gas producers and utilities by state commissions, the FERC's efforts will be blunted or rendered ineffective. For instance, unless gas distributors, intrastate pipelines and Hinshaw pipelines are required to carry gas on a non-discriminatory basis consistent with the FERC's final rules, the FERC's new transportation initiatives in many instances will be wholly ineffectual.

Finally, federal regulation of natural gas sales and transportation historically have played a significant role in creating market imbalances, whether by keeping wellhead prices below the market value of gas, or preventing market participants from responding to market forces. Whatever action the FERC takes in its rulemaking (or whatever action Congress may take), no regulation should be imposed on the industry that will diminish or eliminate incentives for natural gas producers to explore for and develop new gas reserves.

Respectfully submitted,

David W. House
Oklahoma Independent
Petroleum Association

September 19, 1985

67PFESA

Senator NICKLES. Thank you very much, Mr. House.
Mr. Tell.

STATEMENT OF WILLIAM K. TELL, JR., SENIOR VICE PRESIDENT, TEXACO, INC.

Mr. TELL. Thank you very much, Mr. Chairman. My name is William Tell and I am senior vice president of Texaco, and with our acquisition of Getty in 1984 Texaco is presently the largest seller of natural gas of any producer in the United States. So obviously this order has an enormous impact on Texaco, and I am pleased to have the opportunity to outline that for the committee.

I want to compliment you, Mr. Chairman, for holding these hearings because this is one of the most significant events to occur in the energy industry in years and I say that fully aware of what this industry went through in the 1970's.

Senator NICKLES. Could you pull that microphone really close? We've got a lot of people in the back, I think, that would like to hear.

Mr. TELL. I'd like to say that I come here as much in sorrow as in anger. I'll describe the impact, but I think it's also tragic because FERC has correctly recognized that the natural gas industry is so flawed presently with economic dislocations resulting from the cushion gas, the dual pricing, the institutional arrangements that were created under NGPA.

More than half of the volumes have now been decontrolled. The industry is in transition. It is losing end-market share. It is an important industry to this country and that is indeed the trouble. FERC, to its credit, has recognized that it is imperative that ways be found to introduce the discipline of the free market and economic forces and not the kind of public utility straitjacket that we have lived in for 40 or 50 years.

The tragedy is that we are correctly identifying and taking very positive steps to make reform. When it came to block billing it has not only risked legally the entire order being set aside, but it is carrying forward into the future all of the economic dislocations that have created the problem up to this time.

Now block billing, without going into detail and other members of the panel are aware, is the Commission's attempt to government-intervene in the marketplace on the block 2, the new gas, to create pressures to drive those prices down. What an anomaly. That gas was decontrolled the first of this year. The industry was led to believe during the period of shortage in the late 1970's that we were going to go to marginal pricing and if we'd make investments and bring forth supplies we could have the market, up or down.

Now we find the heavy hand of regulation coming on long after the fact not satisfied with what the market produced as to those volumes of gas when they came on and through a jerry-rigged system artificially creating additional pressures to drive those prices down.

That is wrong in concept, but it also has some serious practical effects, because Texaco has recently finished an analysis. We plan to submit it shortly to the FERC. It will show that this block billing will remove $5 billion a year of revenue. Now what does $5 billion mean? Let's put it in perspective.

We hear a lot about billions and even trillions these days. In 1984 the total outlays by the producing sector for exploration and drilling, including dry holes, was only $10 billion. They are going to remove 50 percent of the cash-flow that covered our total exploration in drilling and dry holes in 1984. That is an enormous hit. That also, coincidentally, is in the same order of magnitude as the loss to the industry if the ICD were to be repealed, which the President, upon his examination, found would represent a serious national security concern.

We're talking about something very important. Now it's not just the revenue lost to the industry in the reduced supplies and the reduced throughput and higher prices to consumers that this will produce. But beyond that it is going to leave the industry in the same state of economic dislocation, because rather than remove the cushion it simply transfers it and all of the inequities that that creates in the end market will still be with us. My statement outlines that in more detail.

As I mentioned before, beyond that it's legally flawed. There's no justification for a $5 billion a year rollback in wellhead revenues at a time when this industry is in dire straits, when prices at the wellhead have been flat for the last 2 years, haven't even kept up with inflation. There's no record for that, and it represents one of the largest reneges that has ever occurred.

And when you look at what the Commission said to explain this result, I couldn't believe it and I asked my attorneys how did they rationalize it. They said Congress apparently intended it. Now they didn't review the legislative history of the Natural Gas Policy Act. There is nothing in there that could support that. But they want to include you now in with the renege.

Now it's as if I bought a Treasury bond on the basis of the representation and the good faith of the Treasury and then because of the deficit by administrative action it was announced that the bonds would only be redeemed at 80 percent of face value, and it was rationalized as good for taxpayers and consumers. Well, I tell you, I wouldn't be buying many more bonds in the future if I'd had those kind of ground rules imposed on me.

And you're not going to have the kind of businessman investing this business with this kind of a renege. I very much hope, Mr. Chairman, that the committee can find some way to have the Commission on its own justify this. Don't blame the Congress, because if you look at the history of the NGPA there was nothing in there that said that a renege like this was required or justified. In fact, there are authorities clearly set forth in the NGPA for the Commission to raise prices, flowing gas prices, if they are found to be unjust and unreasonable.

This proposal can be made revenue-neutral at the wellhead, and it should be, and it can be done in a way that makes maximum economic sense, and that would be if the time has come to say that all gas should be sold at current market prices as a commodity—and that's the way crude oil and that's the way refined products are sold—as a businessman I'll go in this business and I'll take the market, up and down. But now I've get the market or my contract or regulation, whichever is less.

It's a one-way street and that's not the kind of environment that an industry whose margins are under pressure are going to make future investments to bring out adequate gas supplies. The Commission has authority, if it's going to take action, to bring the higher-price contracts down to market levels. It can at the same time, under existing authority, without legislation, also arrange to have the lower-priced contracts move up to current contract levels.

That would have all gas selling as a commodity, and in the analysis that we have done and will be submitting to FERC and will be pleased to share with the staff of this committee, the mix of gas today would, under that kind of an arrangement, produce approximate revenue neutrality.

The Commission has a unique opportunity here to get the economy back in the gas business. It can do it in a way that would not hurt the producing segment, and I would very much hope that upon considering these facts that it will make the adjustments I have suggested.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Tell follows:]

STATEMENT OF
TEXACO INC.

SUBMITTED TO THE
SUBCOMMITTEE ON ENERGY
REGULATION AND CONSERVATION
OF THE COMMITTEE
ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

HEARINGS ON
THE NOTICE OF PROPOSED RULEMAKING
OF THE FEDERAL ENERGY REGULATORY COMMISSION
(RM85-1-000)

SEPTEMBER 19, 1985

Texaco is pleased to have the opportunity to provide its comments to the Subcommittee on the very significant Notice of Proposed Rulemaking recently issued by the Federal Energy Regulatory Commission. These proposals, if adopted, will effect the most sweeping changes in the natural gas market in this country since passage of the Natural Gas Policy Act seven years ago. It is indeed appropriate that the Subcommittee conduct these hearings to examine the positive and negative impacts of these proposals, as well as to consider opportunities for effective action to enhance competition in the gas industry which the Commission so far has failed to seize.

INTRODUCTION

Texaco believes the Commission should be congratulated for acknowledging the need for a total revisitation of its gas regulatory concepts and mechanisms. This revisitation is required if the Commission is to promote and encourage the movement of the industry toward free competition which is so obviously well underway. The Commission has recognized that, in essence, its traditional tight regulation of the interstate gas market has been superseded by events. If the Commission's regulations, indeed the Commission's function, is not to be rendered largely irrelevant, something as revolutionary as the Commission's proposals is absolutely necessary. Only by such radical and comprehensive action can the Commission recapture, even partially, an ability to guide and assist the industry to operate "in the public interest."

Texaco feels that the Commission, in its NOPR, has taken some steps towards achieving its goal. It has realized the need to take aggressive action to encourage free and open access to the nation's transportation network, and further to encourage expanded competition for gas markets and supplies by a variety of players. The Commission's proposals in these areas indicate, in large part, a sensitivity to both the needs of the industry and the limitations on the Commission's power. The Commission's proposals for resolving future take-or-pay problems show promise, and with careful implementation could prove effective as a partial solution.

The Commission has also recognized one further major stumbling block in its efforts to realign the gas market into a responsible competitive industry -- the debilitating and distorting effects of the continuing "cushion" of old, below market price-controlled gas. Here the Commission's recommended solution is flawed. The block billing proposal, as presently structured, cannot work as the Commission envisions because it is focused on procedural solutions to substantive problems. The three-part billing proposal is designed to put market pressure on gas which the Commission feels is selling at excessive prices (that is, gas selling in excess of market clearing levels), while insulating old gas from the opportunity to respond to those same market pressures. This is to be accomplished by retaining the below-market price controls and by further directing that old gas be delivered in perpetuity to those who are "entitled" to it because they received it during the past three years.

Only a comprehensive effort to achieve market prices and proper alignment between supply and demand at both ends of the pricing curve can possibly have the positive, competition-inducing effects sought. Adjusting the maximum lawful price (MLP) of old gas upwards to more responsive market levels is the only rational, responsible, workable, and lawful approach to enhancing competition and rationalizing the market.

THE COMMISSION'S BLOCK BILLING MECHANISM PROPOSALS, AS PRESENTLY STRUCTURED, ARE INEFFECTIVE, INADEQUATE, AND IMPERMISSIBLE RESPONSES TO THE MARKET DISTORTION PROBLEM

The Commission has recognized that the distorting and destabilizing effects of the old gas cushion act as a significant barrier to realization of the Commission's competition enhancement goals. The mandatory block billing mechanism is the Commission's proposed solution. Essentially, the proposal is to keep old gas prices at present, below-market controlled rates, and to fix "entitlement" to receive it in existing firm customers, while permitting (and requiring) pipelines and producers to compete for new markets and customers (or old ones newly available) with only "new" gas. The hope is that the old gas would become economically invisible, in the sense that it would no longer affect, in a distorting fashion, marginal economic behavior. As a side benefit, the economic rents on old cheap gas would be "retained" for old firm customers. The Commission asserts that this is "as Congress apparently intended." At the same time, new gas, which the Commission feels is artificially overpriced because of the cushion, would be subject to full market pressure. The anticipated result is that new gas prices would be forced down to market clearing levels, thus sending true, current cost and current value information to consumers and producers, through accurate price signals.

No one could disagree that aggregate economic efficiency, and the public interest, are aided by encouraging gas to be priced at levels which reflect its true cost and true value. Regulatory mechanisms which prevent accurate pricing, indeed which mandate distorted price signals, are not only harmful -- in the long run, they are pointless. Markets must clear in some fashion, and either shortages or price increases are inevitable.

The Commission's error is not that it seeks to promote rational gas pricing, but that its proposed mechanism is inadequate to achieve the goal and, as presently structured, has inherent costs of its own which are excessive and unnecessary. The Commission has failed to realize:

- That its proposals will not eliminate market distortion and inaccurate price signals;

- That the negative impact on domestic gas supplies will be significant;

- That only a revenue neutral approach to rationalizing wellhead gas prices which corrects the underpricing of old gas at the same time market forces are brought to bear on new gas is workable, reasonable, and consistent with the Commission's responsibilities under the NGA and NGPA.

MARKET DISTORTING EFFECTS OF THE OLD GAS CUSHION

The Commission's announced proposal to segregate Block 1 "old" gas prices from Block 2 "new" gas prices will not eliminate the distorting effects of the now existing gas cushion. Indeed, it is likely to exacerbate them. The proposal will drive the effect of the gas cushion down to a regional and even local level, resulting in unequal economic impacts throughout the country.

The Commission's proposal contemplates allocation of the prized gas on the basis of "firm purchases" of old flowing natural gas during an arbitrary base period, 1982 to 1984. Unclear is whether buyers of such old gas (who have already received substantial economic benefits as a result of the purchases during that period) were required to have actually received the gas or whether payments made under minimum bills without actual takes of gas will also qualify to earn "entitlements" to this windfall gas. Also unclear is why purchases on an "interruptible" but consistent basis should not earn "entitlements."

In any event, it is apparent that some local distribution companies will be the primary, if not the only, recipients of the benefits of old gas under the Commission's proposal. These customers, beneficiaries of the plan merely by historical accident, will then have the opportunity (within state and local regulatory limitations) to utilize the cushion so as to either retain the economic windfall for their own coffers, or pass through the cost benefits to favored customers. The resulting unfairness and inequity cannot help but have consequences harmful to the national economy.

Thrusting the gas cushion downstream to the local distribution company level obviously means that the areas served by such LDC's will have an unfair advantage over areas of the country whose distribution systems were not lucky enough to garner some of the old gas entitlement. Regional and even local disparities could become clearly defined. Areas of the country which will have access to the old gas cushion will be able to afford more total energy than areas without such access rights. High entitlement LDC's will have the ability to allow their customers to undercut prices from competitive businesses, increase output, and thrive economically, at then expense of others. Bestowing the benefits of the gas cushion on certain localized areas of the country will mean that new markets for gas will not be developed due to the uncompetitive prices which new businesses would have to bear as a result of established gas-dependent businesses having access to the lowest vintage gas.

While the Commission has effectively pushed down rolled-in pricing from the interstate level to the state and local level, it has lost control and cannot be assured that the cushion gas will be fairly, equitably or efficiently allocated and distributed.

State regulatory agencies may regulate local distribution companies and the end-users, if any, who will be the recipients of such windfall gas based on rolled-in pricing. Or they may not. It must be recognized that states may seek to give the same favoritism to historical end-users by directing such cheap gas supplies to be sold only to those designated by the state regulatory agency. Or, favoritism may be slanted towards another category of end-user. In any event, there is no assurance that the gas cushion will be equitably or properly distributed at the regional and local levels. This proposal then will not have accomplished in any way Congress' concept of a nationally integrated gas network. Moreover, the whole point of the exercise, to send accurate marginal price signals representing the true economic value of gas to the nation's end-users, will be defeated.

Another serious concern is the abortive effect that this discriminatory pricing plan will have on the growth of the economy generally. New businesses, even those who have not yet opened their doors, will be put at a competitive disadvantage from the outset. These economics will dictate their success or failure, and indeed, may stifle initiation of such new enterprises to begin with. Customers in growing areas of the country will never receive any of the low priced gas, or at least not their "fair share," because they were not there to take any of it during the base period. Competition with older subsidized companies under the Commission's plan will simply make it impossible for them to have a viable chance of success or growth. Implementation of such a policy will, therefore, have effects diametrically opposite to those intended by the Commission -- limitation of the expansion of new gas markets and, at a minimum, regional disparities which economically deter gas-dependent businesses in parts of the country on an unequal basis.

POTENTIALLY DEVASTATING EFFECTS OF THE COMMISSION'S PROPOSALS ON DEVELOPMENT OF DOMESTIC GAS RESERVES

In its NOPR, the Commission is primarily concerned with opening access to the gas market so that the benefits and economic efficiencies of free competition can be secured. The purpose of the three part billing proposal is to advance that goal by eliminating the price distortion caused by the old gas cushion. Almost casually, the Commission has expressed the hope or expectation that the proposal will encourage pipelines to "realign their gas costs and prices" and more appropriately "establish" their purchasing prices for gas.

The presumption is that this "realignment" will be accomplished by pipelines putting pressure on producers to lower Block 2 prices while freezing Block 1 prices at their present, below-market levels. What the Commission has not done is to subject that concept to analysis, or indeed to gather any data with respect to it. Thus, the Commission has no idea of the magnitude of the effect on producer revenues, or of the resulting effects on exploration, drilling, and reserve replacement. For this reason alone, Texaco has urged the Commission not to adopt the block billing proposal in its present form until an adequate factual record is prepared and a reasoned examination and determination of likely effects is available.

Although a precise evaluation of the effects is not possible, especially in the short time frame permitted, it has become apparent to Texaco that the loss of producer revenue will be far beyond the Commission's expectations, and that the ultimate effects on the nation's domestic reserve base are likely to be significantly detrimental. The Natural Gas Supply Association has estimated that the annual loss in industry revenue from the block billing proposal could range from $2.45 billion to over $6 billion per year. Our own analysis indicates revenue impact of the same order of magnitude. Texaco calculates that, if Block 2 prices are driven down to market clearing levels within two years, the losses to the producing industry, as compared to the present rolled-in-pricing system, would range from $9.7 billion to $25 billion over four years, depending on market prices. Nor does that represent the total effect on producers, since the losses will continue to cumulate as long as the old gas cushion exists -- which could be into the next century.

These revenue impact figures are of a level which cannot be ignored. Texaco has not attempted to directly correlate this kind of revenue drop with negative impact on the supply of domestic reserves. A decline of this size, however, cannot help but have a very significant downward effect on drilling and exploration for natural gas in the U.S., with direct effects on discovery and development of new reserves. It must be kept in mind that this revenue reduction is exclusively and expressly related to marginal gas revenues. It will not only reduce the amounts of money available for exploration and drilling by producers in general, but will likely affect the decision-making process of producer managers as to where to expend the limited resources available for E&P activities. In this connection, it must be recalled that the decision-making process on expenditure of funds is affected by more than objective calculations. It is affected as well by psychological factors, and rational expectations as to the future direction of both market forces and governmental policy. These expectations are heavily influenced by what government says and does. In the case of the NOPR, these signals, for producers, are decidedly mixed.

The Commission has expressed an underlying philosophy, with which Texaco agrees, that if the gas market can be "freed up" to operate more competitively, it can be relied on to stabilize supply and demand at reasonable, and responsible, prices. Prices must, and apparently will, be permitted to rise to levels necessary to clear the market. Former Commissioner Richard, who recently departed the Commission, has stated, with regard to the policies behind the NOPR, that "[p]rices can go up in a shortage and down in a surplus and we fully intend to let that happen . . . . There is no intention by the Commission to 'stop prices from rising' as far as is necessary to elicit supplies for the future." 1/ Similarly, Commissioner Stalon has stated that "[i]f we create a truly competitive market, if pipelines take the opportunity we've offered, we won't have shortages anymore. What you'll have are fluctuating prices." 2/

The problem for producers is that this new-found confidence in market mechanisms is applied only to the high side, and "fluctions" apparently must always be down. The Commission has expressed frustration over the perceived failure of "long term" contracts (by which it means high priced contracts signed in the 1979-1982 period) to react rapidly enough to market forces. The block billing proposal is its response, designed to isolate Block 2 gas, and force the price rapidly down to market levels. However, while it is considered critical that Block 2 gas be made immediately and fully market responsive, nothing similar is considered appropriate for old gas - its price is to remain frozen at below market levels forever.

This raises two significant concerns. The first is whether this one-sided approach does not mean that the Commission is reneging on an agreement made with producers by Congress itself in passing the NGPA - incentive prices for new gas in return for increased

---

1/ Speech to the Interstate Oil Compact Commission, June 27, 1985.

2/ Quoted in Gas Daily, June 6, 1985.

drilling. This is a critical point which will be developed later. The immediate focus is on the second point -- the effects of such actions on gas development efforts.

The clear signal the Commission is sending producers is that it intends to continually change the rules of the game so that they always lose. If contract prices are above what is thought to be market level, artificial mechanisms will be put into place to force prices down. On the other hand, if prices, because of earlier controls or long term contracts, are below market, they will be kept there. Producers can count on getting only the lower of market levels, old contract levels, or controlled levels established years ago. In deciding how to invest E&P dollars, producers are prepared to accept the risk of market price fluctuations over the life of gas reserves This is the way that crude oil (and petroleum products) are traded, with satisfactory supply/demand equilibrium results. What is not acceptable is a market where the traditional scenario of price controls and long-term fixed price contracts is applied to old gas, or when market prices rise, but market discipline is imposed when prices are coming down.

The Commission may suggest that its new proposal is a one-time adjustment, never to be repeated. Producers, however, have heard that before, as when each new "vintage" price was adopted, as a "one time adjustment," by the old Federal Power Commission. If the Commission wants to send a signal that producers may count on, and should plan for, market responsive prices in the future, the signal must be sent for all gas.

It is argued that, as long as marginal (i.e., new, Block 2) gas prices are at "market" levels, producers are sufficiently rewarded to encourage development of adequate new supplies, even if aggregate revenues are below-market-level amounts. However, this argument fails to take into consideration the psychological and rational expectation arguments discussed above. More importantly, this marginal pricing/supply response theory works, if at all, only over the "long run" -- after producers have had time to adjust to both the present downward spiral of gas prices, and the dramatic revenue shortfall over the next few years anticipated from adoption of block billing. And, as John Maynard Keynes reminds us, "In the long run, we are all dead."

Most serious gas exploration and development today is being performed in frontier areas, such as deep offshore waters. In these regions, development work to bring a field to production can take five years or more, even after exploration efforts have been rewarded with a successful find. Arguing that government policies are designed to produce an average of adequate supplies and deliverability of natural gas over the next 25 years will not prevent a shortage and curtailment in five or ten years, in the same way that saying a river averages only one foot in depth will not prevent a man from drowning in the middle.

Expectations do affect behavior. If producers are led to expect arbitrary governmental action to artificially force and keep wellhead prices (and thus producer revenues) down as the norm, interest in pursuing gas development possibilities will naturally suffer. On the other hand, adequate market responsive prices for all gas, and a justifiable expectation that this will continue to be the case, will produce adequate supplies of gas for the nation now and for every year to come, at reasonable and necessary prices.

These potentially disastrous effects on domestic gas exploration and production efforts must be considered against the existing backdrop of a U.S. oil and gas industry which is already suffering through its worst depression in fifty years. The factors at play -- the worldwide oil glut and declining oil prices, the significant drop in demand for, and prices of, both oil and natural gas in the U.S., the major restructurings and debt burdens taken on by most oil companies in recent years, and the increased costs (and lowered success ratios) of finding new reserves as exploration efforts move to frontier areas -- all have combined to the natural and expected result, dramatically lowered profits and cutbacks in the exploration efforts. Earnings of the 21 leading U.S. oil companies in 1984 (before the most significant drops in oil and gas prices, which have occurred in the last nine months) were 36 percent below the peak of 1980. Domestic capital expenditure by those same companies fell from 1981 to 1984. 3/ Total U.S. drilling has dropped 60% from its 1981 high. 4/ The implications for U.S. reserve replacement are ominous.

3/ Source: American Petroleum Institute

4/ Source: Hughes Tool Company

Most significantly, the Energy Information Administration has recently reported that 1984 additions to U.S. natural gas reserves were only 78% of production for that year. New discoveries of dry natural gas in 1984 were 13.5 Tcf, compared to production of 17.2 Tcf. Natural gas reserves dropped to their lowest point since 1951, at 197.5 Tcf. 5/ Drilling activity across the industry is substantially down in 1985 over even 1984's depressed levels. Thus, even more dramatic reserve-addition-to-production comparisons can be anticipated for this year.

During this same period, producer prices have remained static, and the current trend is downward. The EIA reports that the average wellhead price for natural gas in April of 1985 (the latest data available) was $2.67 per Mcf, one cent higher than the price in January of 1983. During that 27-month period, the highest average price was $2.70. Current spot prices for gas are about $2.30, and dropping fast. At the other end of the pipeline, average residential prices for 1984 were less than one-tenth of one percent over 1983. Clearly, there is no rational economic justification for the Draconian revenue rollback of producer prices implicit in the Commission's present proposal.

5/ Source: EIA, for data from 1976. Prior years' data from American Gas Association.

The Commission, of course, is not responsible for the general state of the U.S. oil and gas industry. It does however, have the responsibility and the obligation to adopt policies designed to ensure that American consumers are provided with "adequate supplies of natural gas at the lowest reasonable cost." As the damage to the national economy caused by the gas curtailments of the 1970's demonstrated, the "adequate supplies" part of that formula is as, if not more, important than "lowest reasonable prices." Moreover, if supplies are inadequate, prices kept below market levels by regulatory action may be "low," but by definition are not "reasonable."

Texaco agrees that demand and supply will be stabilized at reasonable and proper levels if prices are permitted to fluctuate in accordance with market imperatives. Adoption of the present block billing proposal, however, is likely to create an artificial, Commission-imposed shortage which will require an equivalent, artificial "price spike" to clear the market and call out needed new supplies. The cost, to consumers and the industry, in dollars and in disruption of economic activity, will be more than just high. It will have been unnecessary.

THE COMMISSION SHOULD ADDRESS THE OLD GAS CUSHION DIRECTLY

Legal Authority

The Commission's suggested approach to the old gas cushion problem will not have the hoped-for effects of eliminating market distortions and encouraging correct consumption/production decisions. Moreover, it will have far-reaching, debilitating effects on domestic supplies, ultimately resulting in assured and dramatic effects on gas prices which are not in the public interest. The only rationale offered by the Commission for assigning the economic rents from permanently price controlled gas to a specific class of historic customers, in perpetuity, is the unsupported statement that "Congress apparently intended" it. No citation is given for this presumption, and the record before the Commission is markedly absent of any support for it.

It is clear, on the contrary, that if Congress "intended" the Commission to do anything with regard to Section 104, 106, and 109 gas, it was to raise the maximum lawful price above those provided in Title I of the NGPA, if the new rates were found "just and reasonable." Overwhelming evidence has been presented to the Commission, on numerous occasions, that the present MLP's of Section 104, 106, and 109 gas are well below any measure of "just and reasonable," whether evaluated from commodity value, replacement value, or from a traditional FPC producer cost of service approach. The Department of Energy has opined that pricing old gas at current resource cost levels would not only solve existing price distortion and inefficient economic decision-making problems in the gas market today, but would likely result in lower overall prices, because of increases in production of total volumes of old, cheaper gas. DOE has also noted the significant gains in economic value for the nation, which would come from permitting old gas MLPs to rise to higher just and reasonable levels, due to the tremendous amounts of gas which could be produced from old fields, which now will never be realized because of premature abandonment. DOE estimates the amount of this presently unproducible but available gas is 27 trillion to 48 trillion cubic feet. Industry estimates suggest this view is, if anything, conservative.

If the Commission succeeds in its present intention of permanently committing old gas to a specific and fixed class of old customers at current, below market prices, neither producers nor pipelines will have any incentive to see that this gas is ever produced, and trillions of feet of the cheapest, most easily producible gas available in the United States will be lost forever.

Numerous proxies for an appropriate "just and reasonable" level for old gas to be set at have been suggested. The Commission itself has provided a simple, effective, and reasonable rationale for permitting old gas prices to be adjusted upwards to a precisely accurate "just and reasonable" level. The Commission has proposed that, after the four-year transition to a presumably open and competitive gas market, any pipeline which has elected to provide open transportation can charge its customers any price for Block 2 gas, and that price will be presumed to be "just and reasonable" within the meaning of the NGA. The price is not freed from price controls or "administratively deregulated." The Commission has merely said that "when customers can purchase from alternative merchants, the oversight of gas purchasing practices can be effectively augmented by greater reliance upon market forces," 6/ and that under these circumstances, the fair market price is the legitimate NGA "just and reasonable" rate.

The Commission has proposed dramatic changes in the way the gas market is regulated, to the end of creating an open, fully competitive industry. If, under those circumstances, the NGA just and reasonable rate for pipeline gas is the going market rate, then the Commission's obligation under the NGPA to raise Section 104, 106 and 109 wellhead MLP's to higher levels, if they are "just and reasonable" under the NGA, is also triggered. The Commission should permit old gas, the identical commodity, to be sold at more market responsive rates precisely because those rates are the just and reasonable ones.

Congressional Intent And The Commission's Responsibilities Under The NGA And The NGPA

The Commission has been urged to take the necessary and appropriate steps to adjust old, below-market controlled gas to more just and

---

6/ NOPR at p. 46.

reasonable rates before. The distorting effects of the cushion (and the inadequacy of any attempt to "disguise" it), the lack of justness and reasonableness in present price levels, the tremendous positive effects on future supply of eliminating the cushion, and the potentially disastrous supply effects of a failure to deal with it, all argue for immediate, affirmative action to remove this barrier to a competitive and efficient gas market.

The Commission, however, in evaluating its future action with regard to the NOPR, is obliged not to look at the old gas problem in isolation, but in connection with its other proposed actions. Its attempts to open transportation, to encourage pipeline competition, and to resolve problems remaining from the existence of the cushion in the past, all will be harmed by permitting extension of the cushion into the future. The Commission should examine its proposed treatment of old gas in concert with its treatment of new.

The Commission's proposal to set up the gas market in a way which allows market pressure to be brought to bear on only new gas, driving it to lower market-clearing rates, while retaining unjustified price restraints on old gas, is not just harmful to gas supply development, and bound to be ineffective in producing a responsive, working gas market. More than that, it is an impermissible and unlawful exercise of the Commission's authority far exceeding the intent of Congress in adopting the NGPA.

The NGPA was Congress' reaction to the continuing and increasingly dangerous problem of gas shortages caused by aggressive regulation of gas at below market prices. The inability of the interstate market to call forth adequate supplies at existing controlled prices was acknowledged by all. Even the Federal Power Commission recognized the need to encourage supply development, but appeared to feel limited in its range of options by having "to provide an adequate supply of natural gas at the lowest possible cost to the consumer." 7/

The National Energy Act, President Carter's predecessor of the NGPA (which had fewer price incentive proposals than were ultimately included in the NGPA), had as its purpose "to bring the natural gas market into better balance by reducing the demand for natural gas and increasing the supply through the establishment of a uniform and incentive-based pricing system for new natural gas which provides fair and equitable producer revenues and protects consumers." 8/ The NGPA, as finally adopted, included a variety of "incentive" prices for various kinds of "new," or high-cost, or low production types of wells, for the express purpose of encouraging producers to incur drilling expenses in order to develop needed new reserves. At the same time, price controls were kept on "old" gas, essentially at the levels

---

7/ National Rates for Natural Gas, 56 F.P.C. 2698 (1976) (Op. No. 770-A).

8/ H.R. 8444, §401(b)(2), 95th Cong., 1st Sess. (1977).

previously established by the FPC as "just and reasonable." The obvious point was that, since the FPC had already cleared those prices as being "just and reasonable," they were the appropriate price for already flowing gas -- the Commission was directed, however, to use authority granted in the NGPA to raise those rates if higher ones were found to be just and reasonable. 9/

The plan, with some stumbling, has worked in the sense that immediate drilling was encouraged, and discoveries were made such that there is currently an excess of deliverability. Now that there is a (temporary) excess, however, the Commission apparently feels that some new gas remains unnecessarily priced above "true" market clearing levels. Accordingly, it proposes to force the price of new gas down, by isolating it from old price controlled gas and forcing it to compete for new markets alone, against alternate fuels, conservation, and imports.

It can be argued that producers are "entitled" to above market prices for new gas as a reward for undertaking the drilling programs the country needed. The argument would be that Congress offered a specific deal -- incentive prices in return for new drilling. 10/ Now that producers have fulfilled their end, the

---

9/ See Sections 104(b)(2), 106(c), and 109(b)(2) of the NGPA.

10/ Congress was fully aware that deregulation of new gas, combined with rolled-in pricing, would result in above market incentive prices for the new gas. See, for example, pp. 98-100 of Part 4 of House Report No. 95-496 (95th Cong., 1st Sess.).

Commission is unwilling to live up to Congress' offer. The Commission would respond no doubt with the view that gas markets work -- supply meets demand and prices are fair and equitable -- only when market forces are allowed to work. Its block billing mechanism, it believes, is only a way for the regulatory apparatus to "step aside," to permit market forces to signal the true value, the "just and reasonable" price, of gas.

The Commission, however, is not just getting out of the way of market forces. It has set up an artificial marketing device which has as its acknowledged purpose bringing market pressure to bear on part of the available gas, while isolating the rest of the gas from those same forces.

If new gas prices are forced down to "market" levels (presumably alternate fuel costs) by this artificially constructed and Commission imposed proxy for the free market, while old gas continues to be controlled below market levels, producers in the aggregate will receive less revenue than would be available under true market conditions. Since markets ultimately must clear, of course, the long term consequences of this differential must be future shortages as supply drops, and eventual price spikes to make up for the shortages. Immediately apparent, however, is the simple fact that the Commission will have taken action in excess of its authority and in violation of the will of Congress.

The structure of the NGPA is clear evidence that Congress did not intend for producers to receive, as an industry, less than the total revenue, the aggregate price level, needed to draw forth adequate supplies. Congress permitted retention of price controls on old gas at below market levels only as part of the package which included incentive prices for new gas (and even then granted the Commission the authority to raise, but not lower, old gas prices if they were found to be too low). Old gas prices at below clearing levels can be argued to be just and reasonable only so long as they are balanced by incentive prices. If the Commission determines that, in the interest of enhancing competition and increasing overall economic efficiency, it must now interfere with the market by imposing a jury-rigged billing device to eliminate any incentive prices, those below market old gas prices are clearly no longer just and reasonable. Under the clear logic of the NGPA, the Commission must act to permit old gas prices to react to the same market forces to which new gas is being forced to respond. Anything less is not just impermissible discrimination against producers, but is directly contradictory to the mandate of Congress, and an abuse of the Commission's discretion.

Methodology For Addressing Old Gas Prices In A Revenue Neutral Approach

The point at which old flowing gas prices are allowed to react normally to market conditions is the point at which the natural gas market will be effectively and efficiently operating as a competitive gas market for the ultimate benefit of consumers. However, Texaco views a transition period for the adjustment of such old gas prices as being justifiable and in keeping with the

Commission's desire to assure a smooth transition to the desired market environment. The four-year period proposed by the Commission to allow the pipelines' firm sales customers to free themselves from mandatory purchase obligations suggests one possible transition period for old gas prices. A shorter period, however, may be more appropriate if economic analysis indicates the Block 2 higher priced gas will move downward to current market levels in a period shorter than four years. This mutuality of adjustment would effect market transitions at both the demand and supply ends.

Over the appropriate period, the following transitions are within existing legal authority and could be utilized:

(1) Raising the just and reasonable price limitations on all old gas volumes each month by a proportional amount designed to permit all volumes to reach market equilibrium at the time Block 2 gas volumes reach such level.

(2) Raising the just and reasonable price limitations on a percentage of each producer's old gas volumes each month, by vintage or section, and by contract, to the going market price (thus the presumed "just and reasonable" rate). Market price would be established by blanket abandonment of certificated sales, and permitting the gas to be resold on the

open market, with a right of first refusal retained by the existing purchaser.

(3) Permitting abandonment and resale, again at market rates (and again with a right of first refusal), by either the pipeline or the producer, of that portion of each pipeline's system supply which has been released back to the pipeline by its firm customers under the contract demand reduction proposal (proposed new §157.21). The pipeline would calculate each year what percentage of its system supply was released back to it, and could elect to be released from that percentage of required take of any of its purchase contracts it chose. Similarly, its suppliers could elect to have released for resale the same percentage of gas from any of their sale contracts with the pipeline.

(4) Immediately permitting old gas prices to be judged just and reasonable at market rates upon expiration, termination, or renegotiation of existing contracts.

Blanket abandonments based on categories of gas, or types of contracts involved, could be utilized by the Commission to allow such transitioning of old gas prices and assimilation into the marketplace. It should be emphasized that contract abrogation is not a component of these proposals. Increases in prices for old gas would only be permitted where contract authority exists.

Since the block billing proposal is both mandatory and immediately effective, it is apparent that its effects on Block 2 gas will be rapid. Transition of Block 2 gas to market levels will probably be substantially complete within, at most, two years. Accordingly, an equivalent two-year transition period for old gas to more market responsive levels would appear appropriate. Our analysis indicates that, even under the most optimistic forecast of market clearing prices, action by the Commission to phase the price of old gas to just and reasonable, market responsive levels, when combined with the downward effects of the block billing proposal on new gas, would still result in a net negative impact on producers of about $1.7 billion over a two-year period.

Adoption of the Commission's proposed regulations substantially in the form presented in the NOPR (with only modest technical adjustments as suggested by Texaco and other producers), combined with administrative action to raise old gas prices over an appropriate transition period to higher, more market-responsive, just and reasonable rates, will have a substantially revenue-neutral effect on the interstate gas market; will allow a transition to an almost entirely market-driven, supply/demand pricing structure, which eliminates market distortions; will produce a gas industry which is highly competitive, providing open availability for all purchasers and suppliers of gas and transportation services to meet and reach reasonable bargains at reasonable prices; and most of all, will guarantee to the consumers of the nation, steady, reliable, and adequate supplies of gas at the minimum reasonable price.

It is Texaco's firm conviction that complete and total elimination of the old gas cushion is the only way to eliminate the market distortion the Commission has recognized. The sooner this is done, the sooner the gas market will recover from its present inability to react quickly and smoothly to proper price signals.

Even so, it is worth remembering that economic benefits of rationalizing gas prices accrue arithmetically, rather than in quantum steps. That is to say, immediate and total market levelling of all old gas is not required to achieve any benefits at all. Incremental steps toward fair market pricing and elimination of the old gas cushion provide correspondingly incremental benefits in greater gas supplies, lower marginal costs, levelling of the playing field, and elimination of market distortions.

Whatever the approach, the Commission should realize that it has, today, the last best opportunity to resolve the problems of the gas market caused by years of overregulation and misguided policy choices. Continuation of these policies, by perpetuation of the market distortion inherent in artificially underpriced gas, will inevitably result in future supply imbalances, erratic price swings, and the human and economic costs of gas curtailments. The Commission can, and should, act to prevent this now. Support by this Subcommittee for such action would be helpful and welcome.

RJP19A/d

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

REGULATION OF NATURAL GAS	§	
PIPELINES AFTER PARTIAL	§	DOCKET NO. RM85-1-000(Parts A-D)
WELLHEAD DECONTROL	§	

SUPPLEMENTAL COMMENTS OF TEXACO INC.

TEXACO INC. (Texaco), a major producer of natural gas, filed extensive written Comments in response to the Notice of Proposed Rulemaking (NOPR) issued by the Federal Energy Regulatory Commission (Commission) in the captioned docket. It also made an oral presentation to the Commission at the public hearing held on August 1 and 2, 1985, in this proceeding. At that public hearing, certain questions were raised by the Commission, in particular by Commissioner Stalon, with regard to the fairness of suggestions made by several parties, including Texaco, that the Commission should directly address the question of old, below-market priced gas. Questions were also raised by the Commission regarding supply and revenue impacts of such proposals in comparison to either the proposals contained in the NOPR or the status quo. 1/

In light of these queries, Texaco has undertaken a study of the overall revenue effects of the Commission's block billing proposal as compared to the status quo. This study demonstrates that adoption of the Commission's proposal, without a companion higher just and reasonable determination for old gas rates, will

---

1/ Official transcript at pp. 555-556 and 559-561.

result in average annual revenue reduction of $5 billion to producers, with serious implications for the future development of natural gas supplies. On the other hand, adjusting the maximum lawful prices (MLP) on old gas as authorized by NGPA, when combined with block billing, can permit the NOPR to achieve approximate revenue neutrality at the wellhead.

Such action would have the added benefit of 1) removing a major legal flaw from the existing NOPR; 2) permitting all gas to sell as a commodity at current market levels, eliminating the economic distortions of rolled-in prices; and 3) avoiding a major reduction in producer funds available for future exploration.

Texaco respectfully requests permission to file these Supplemental Comments and the attached study with the Commission and have them considered as part of the record in this proceeding.

I.

BACKGROUND:

TEXACO'S POSITION REGARDING BLOCK BILLING AND OLD GAS

Much of the NOPR is designed to move the Commission's regulations in a positive, competitive direction, particularly with regard to the proposals to establish non-discriminatory transportation, and the efforts to encourage increased pipeline-to-pipeline competition and voluntary resolution of take-or-pay problems. The Commission's block billing plan, however, is an artificial structure designed to force new gas prices down to market levels while keeping old gas prices at below-market clearing prices. Texaco's position is that old gas prices at below-market levels are just and reasonable, if at all, only so long as they are balanced by incentive prices. The corollary of this point is that, if the Commission intends to force new gas prices down by its block billing proposals, then under the logic of the NGPA, it must act to permit old gas prices to react to those same market forces.

In its written comments, Texaco provided several suggestions regarding mechanisms as to how old gas prices could be raised, in a workable and non-market-disruptive fashion, to more market responsive, higher, just and reasonable rates. The most practical approach would be to phase up the MLP on Block 1 gas on a monthly basis commensurate with the estimated rate of reduction of Block 2 gas under the NOPR. This would not be administrative deregulation, nor contract abrogation. 2/ It would simply

---

2/ Nor is the Commission barred, by the Supreme Court's decision in FPC v. Texaco Inc., 417 U.S. 380 (1974), from considering market prices in exercising its authority under the NGPA to raise old gas rates, as was suggested at the public hearing. The Court itself made that clear in FERC v. Pennzoil Producing Co. where it said that:

> [In Texaco] we did not indicate that producer or pipeline rates would be per se unjust and unreasonable because related to the unregulated price of natural gas. Texaco did not purport to circumscribe so severely the Commission's discretion to decide what formulas and methods it will employ to ensure just and reasonable rates. Indeed, the decision underscored the wide discretion vested in the Commission.

439 U.S. 508, at 516-517 (1979).

reflect a determination that, under the market-oriented scheme of regulation contemplated by the NOPR, the sale of natural gas as a commodity at current market rates would be just and reasonable. Higher prices for Block 1 gas would be permitted only to the extent authorized under existing contracts. This approach is comparable to the successful method utilized when crude oil price controls were removed in 1979-80.

II.

REVENUE AND SUPPLY IMPACT OF VARIOUS PROPOSALS

In partial response to the questions raised by the Commission at the public hearing on August 2, Texaco undertook a study to determine the likely revenue impact of the Commission's block billing proposals on the producing industry. A projection was made of total producer revenue from the sale of interstate gas over a four-year period if block billing is adopted as proposed. Although the NOPR makes block billing universal, mandatory , and immediately effective, a conservative assumption was made that Block 2 prices would take two years to be forced down to market clearing prices. This projection was then compared to estimates of total producer interstate revenue under the present rolled-in pricing system, to determine net impact on revenue from block billing.

A second projection was then run under an assumption that, while adopting block billing, the Commission takes action to increase the MLP of Block 1 gas to approximately market clearing levels over an equivalent two-year period. The combined results of the Block 2 price declines and Block 1 increases were again compared with the present system for net revenue impact. For all projections, every effort was made to take into account all relevant factors, including anticipated changes in market clearing prices for gas over the next four years, 3/ expected inflation, the fact that Block 2 gas is likely to decline in price over the next four years in any case, the effects of declines in production of Block 1 gas over current volumes, changes in the level of demand, changes in the supply mix (including imports), and other factors.

Texaco's analysis, which is provided in Attachment A to these Supplemental Comments, indicates that adoption of the block billing proposal, without any change in the MLP of old gas, will result in a loss to the producing industry of an average of over $5 billion per year in the first two years. The cumulative total over four years is almost $17 billion. Nor does this represent the total effect on producers, since the revenue losses will continue to accumulate as long as the old gas cushion exits--which will probably be into the next century.

An annual reduction in producer wellhead revenue of $5 billion will have a devastating adverse effect on the quantities and prices of future gas supplies available to consumers. Such a reduction is 50% of the total expenditures made by the industry

---

3/ The market clearing price forecasts for natural gas over the next four years which the study is based on are estimates provided by Foster Associates, Inc.

in 1984 for exploratory and development drilling for natural gas, including dry holes. This, combined with the negative psychological effects of the government reneging on the investment ground rules held out to the industry under the NGPA, can be expected to reduce future reserve additions by 30% or more.

The signal the Commission is sending producers is that it intends to continually change the rules of the game so that they always lose. If contract prices are above what is thought to be market level, artificial mechanisms will be put into place to force prices down. On the other hand, if prices, because of earlier controls or long term contracts, are below market, they will be kept there. Producers can count on getting only the lower of market levels, old contract levels, or controlled levels established years ago. In deciding how to invest E&P dollars, producers are prepared to accept the risk of market price fluctuations over the life of gas reserves. This is the way that crude oil (and petroleum products) are treated, with satisfactory supply/demand equilibrium results. What is not acceptable is treating producers one way when prices are rising, and another when prices are coming down.

An average annual/reduction in producer wellhead revenue of $5 billion must be considered against the existing backdrop of a U.S. oil and gas industry which is already suffering through its worst depression in fifty years. The Energy Information Administration has recently reported that 1984 additions to U.S.

natural gas reserves were only 78% of production for that year. New discoveries of dry natural gas in 1984 were 13.5 Tcf, compared to production of 17.2 Tcf. Natural gas reserves dropped to their lowest point since 1951, at 197.5 Tcf.[4] Drilling activity across the industry is substantially down in 1985, below even 1984's depressed levels.

Over the past two and one-half years, producer prices have remained essentially static, not even keeping pace with inflation. The current trend is downward. The EIA reports that the average wellhead price for natural gas in April of 1985 (the latest data available) was $2.67 per Mcf, one cent higher than the price in January of 1983. During that 27-month period, the highest average price was $2.70. Current spot prices for gas are about $2.30, and dropping fast. At the other end of the pipeline, average residential prices for 1984 were less than one-tenth of one percent over 1983. Clearly, there is no rational economic or legal justification for the Draconian revenue rollback of producer prices implicit in the Commission's present proposal.

As an alternative approach, the concept of combining block billing with Commission action to increase Block 1 prices to more market responsive, just and reasonable rates would significantly ameliorate the revenue losses to producers. The net revenue effect on producers will still be significantly negative for the first two years (a loss of approximately $5.9 billion) but is substantially revenue neutral over the following two years. The average annual loss for the four years is about $1.5 billion. While Texaco has not attempted to project revenue effects for more than four years, given the uncertainty of long-range price forecasts, it appears likely that at least some of the cumulative deficit will be made up in future years. The continued existence of a significant net deficit after four years, however, indicates that the Commission should in fact permit a Block 1 phaseup at a more accelerated pace, in order to achieve complete revenue neutrality.

---

[4] Source: EIA, for data from 1976. Prior years' data from American Gas Association.

The Commission's NOPR seeks constructively and creatively to address serious structural problems plaguing the natural gas industry as it makes the necessary transition to become more competitive and market-oriented. The block billing proposal is so seriously flawed, however, that it more than offsets the economic benefits from the other aspects of the NOPR and places the entire proceeding in serious legal jeopardy. Moreover, the two to three years of investment uncertainty that will hang over the industry during the pendency of judicial review will cause irreparable harm to both the industry and gas consumers. Equally important, a unique opportunity to price all gas as a commodity, similar to competitive fuels, without raising burner tip prices, will be lost. Experience with prior Congressional initiatives seeking this objective over the past thirty years strongly suggests it may be now or never.

Texaco urges the Commission to consider these Supplemental Comments, to amend and clarify its proposals, and to adopt new regulations in accordance with the analysis and recommendations set forth above.

Respectfully submitted,

KAREN A. BERNDT
RALPH J. PEARSON, JR.
ATTORNEYS FOR TEXACO INC.
P. O. Box 52332
Houston, Texas 77052
(713) 650-4297

By: Ralph J. Pearson Jr.
RALPH J. PEARSON, JR.

Houston, Texas
September 23, 1985

ATTACHMENT A

EXECUTIVE SUMMARY

Study regarding a proposal to adjust prices
of "old" interstate gas to market levels: Net effects
on producer interstate natural gas revenues when
combined with expected revenue decline from proposed
"block billing" of "new" gas as compared to
continuation of rolled-in pricing.

Under the rules proposed by FERC in RM85-1-000, a three part billing would be required of the interstate pipelines in invoicing their purchasers' -- a separate billing for Block 1 (old) gas, a second separate billing for Block 2 (new) gas, and a third billing for non-gas costs, i.e., transportation, storage, etc.

It is the view of many and the apparent expectation of the FERC that separate billing of Block 2 (new) gas will drive the price of new gas down to a significantly lower level than would be the case if the current practice of rolled-in pricing, or computation of a Weighted Average Cost of Gas (WACOG) is continued.

Should this occur, all revenue losses due to a decline in Block 2 prices will be borne by gas producers to the detriment of finding new supplies.

A study was performed to assess the impact of Block 2 revenue decline on gas producers industry-wide, should block billing be instituted by the FERC. The results of the study show that, assuming Block 2 prices decline to market clearing levels in two years, a revenue decline averaging five (5) billion dollars per year will occur over the first two years.

If it is assumed that Block 1 gas were allowed to adjust upward to market clearing levels over the same two year period, a significant net revenue deficit would still exist at the end of the first two year period (a 5.9 billion dollar deficit). However, during the third and fourth year, an approximate "revenue neutral" situation results (a reduction of 978 million in the third year and a gain of 1.4 billion the fourth year).

DESCRIPTION AND METHODOLOGY

Proposal to Offset the Decline In Interstate Natural Gas Revenues Resulting from Block Billings in FERC's NOPR in Docket No. 85-1-000

This study concerns the likely behavior of interstate natural gas prices and revenues over the next four years, assuming FERC's block billing procedure is initiated in the near future.

Many hold the view that Block 2 prices and revenues will be rapidly forced downward toward the market clearing level in contrast to continuation of rolled-in pricing as at present, whereby the Weighted Average Cost of Gas (WACOG) is used as the "standard" for comparison.

An alternate proposal is also presented to offset the Block 2 price and revenue decline so that a "Revenue Neutral" situation will be approached within the four year period as compared to continuation of rolled-in pricing and WACOG.

The results of the study are presented in four schedules including a listing of assumptions used. Three alternative scenarios are involved and are also described in Schedule 1. Scenario I assumes a status quo situation exists through 1989 with retention of rolled in pricing and WACOG, whereby there is some modest decline in Block 2 prices because of the persistence of the gas bubble, conservation, relatively static demand, depressed world oil prices, and Block 1 prices remain regulated. Scenario II assumes block billing with Block 2 prices declining faster than in Scenario I to market clearing prices (MCPs) over a two-year period starting January 1, 1986, and block 1 prices remain regulated as at present. Scenario III assumes a two year phase-up in Block 1 prices to market clearing levels, with Block 2 prices declining to market in the same two year period.

Schedule 1 also summarizes the new gas, old gas and Block 1, Block 2 revenues and changes therein as computed in more detail in Schedule 2 where relevant price and volume data are displayed and the 1985 starting volumes and prices are shown.

Schedule 3 sets out the interstate Block 1 and 2 volume projections together with reserves additions, required import volumes, indicated decline rates and interstate demand.

Schedule 4 summarizes the assumptions used in the study. Those assumptions are embodied in Schedules 2 and 3.

All prices and revenues are set out in the study in current dollars.

Schedule 4

Assumptions Used in the Study

1. U. S. Reserves Additions will average 16 Tcf/yr. over the next 4 years.

   Basis: EIA reserves additions shows the average of the median reserves additions with and without adjustments respectively, is 16 Tcf/yr, for all types gas, dry basis, lower 48 states for period 1979 through 1983 with an estimate of 16.6 Tcf for 1984 included.

2. Five-eights (0.625) of U.S. lower 48 production volumes are interstate volumes. Therefore, the annual reserves additions attributable to interstate gas is 10 Tcf: 16 Tcf x .625 = 10 Tcf/yr.

   Basis: The 0.625 was determined over a 5 year period 1980-1984 as the average of the volume of interstate production to total U. S. production for the lower 48 states.

3. The average depletion period for new gas reserves additions is assumed to have a 20 year producing life, or 1/20 of reserves per year initially; 10 Tcf/yr x 1/20 = 500 Bcf/yr production from interstate reserves additions. Furthermore, the 500 Bcf/yr new production does not decline over the 4 year period because of the gas glut, which has resulted in so much surplus deliverability that the new gas production is at such a low rate (20 year life) that it does not start declining until after the 4 year period studied, 1986 through 1989.

4. With respect to the existing Block 2 gas as of 1/1/86; it declines at a rate of 5 percent per year over the next four years. The decline rates could be higher except for the gas glut, which will result in the existing Block 2 gas decline rate being reduced from approximately 10 percent per year to approximately 5% per year.

5. Block 1 decline rates are reduced to 5 percent per year for the same reasons stated in items 3 and 4above with respect to Block 2 gas. Since the price of Block 1 gas increases under all three scenarios studied, some enhanced recovery reserves could be expected to be added to Block 1 gas, thus tending to slow down the decline rate further. Current wisdom is that the gas glut will last at least through the decade -- until after 1989.

6. Assume interstate gas demand increases at a rate of 2 percent per year over the next four years, from 11.5 Tcf in 1985 (includes imports) to 12.4 Tcf in 1989.

7. Assume the deficiency in domestic production is made up by predominately pipeline gas imports, all priced at the BLock 2 level.

8. Assumptions and sources regarding prices and inflation rates are as follow:

   A. A 1985 Block 2 price of $3.60 and a Block 1 price of $1.46, as well as the Block 1 and Block 2 volumes (by imputation), are taken from Tables A-1 and A-2 of Appendix A attached to the Comments of the Natural Gas Supply Association (NGSA) filed with FERC in Docket No. RM85-1-000 (Parts A-D) on July 15, 1985 as the starting prices and volumes in the study. These data were generated for NGSA by Foster Associates from PGA filings of 25 major interstate pipelines.

   B. A forecast of market clearing prices through 1989 was furnished by Foster Associates, Inc., a Washington, D.C. economics consulting firm. The forecast is considered "preliminary" pending publication of a client report within one or two months. The forecast was converted from constant 1985 dollars to current dollars for this study by Foster Associates preliminary estimate of 4.2 percent per year inflation increases over the four year period 1986 through 1989.

   C. Block 2 prices;

      (1) Price will decline even with the status quo, (rolled-in pricing), because market clearing price is declining to levels below current Block 2 prices.

      (2) Block 2 prices will decline to market clearing levels in 2 years.

   D. Block 1 prices;

      (1) If continue under controls for next two years, Block 1 price will increase at 4.2 percent per year (corresponding to item B. above), plus 0.2 percentage point per year as specified by NGPA, for a total inflation adjustment factor of 4.4 percent per year. The increase would be from $1.46/mcf in 1985 to $1.73/Mcf in 1989.

(2) If controls are removed and a 2 year phase up is allowed, Block 1 gas prices will increase from an average of $1.46 to $2.39 in 2 years.

E. All prices and revenues are expressed as current dollars.

SCHEDULE 1

SUMMARY OF DECLINES IN INTERSTATE NAURAL GAS REVENUES RESULTING FROM BLOCK BILLING VERSUS ROLLED-IN PRICING, INCLUDING PROPOSED PHASE-UP OF BLOCK 1 PRICES TO MARKET LEVELS

1986 - 1989, MILLION DOLLARS

	SCENARIO DESCRIPTION	1986	1987	1988	1989	TOTAL
I.	Status Quo-Retain Rolled-In Pricing					
	New gas (Some decline in price)	$26,476	$26,304	$26,803	$27,204	$106,787
	Old gas (Remains regulated)	5,993	5,955	5,906	5,847	23,701
	TOTAL	32,469	32,259	32,709	33,051	130,488
II.	W/NOPR-Block Billing; Block 1 Stays Reg.					
	Block 2-two year Price Decline to Market	$22,816	$19,646	$22,480	$25,118	$90,060
	Block 1-Remains Regulated	5,993	5,955	5,906	5,847	23,701
	TOTAL, Blocks 1 and 2	28,809	25,601	28,386	30,965	113,761
	Scn. II vs I-Revenue Decline (All Block2)	-$3,660	-$6,658	-$4,323	-$2,086	-$16,727
III.	W/NOPR-Block Billing; Block 1,2 Year Phase-Up					
	Block 2 - 2 Year Price Decline to Market	$22,816	$19,646	$22,480	$25,118	$90,060
	Block 1 - 2 Year Phase-Up to Market	7,373	8,951	9,251	9,363	34,938
	TOTAL, Blocks 1 and 2	30,189	28,597	31,731	34,481	124,998
	Revenue Increase, Block 1	+$1,380	+$2,996	+3,345	+$3,516	+$11,237
	Scn. III vs I-Net Change in Revenue	-$2,280	-$3,662	-$978	+$1,430	-$5,490

SCHEDULE 2

INTERSTATE GAS VOLUMES, PRICES, REVENUES AND CHANGES
BLOCK BILLING VERSUS ROLLED-IN PRICING
ESTIMATES-1985, PROJECTIONS 1986-1989, CURRENT DOLLARS

Line No.		1985	1986	1987	1988	1989	4 YEAR TOTAL 1986-89
1.							
2.	Block 2 (New) Gas, Incl. Imports, Bcf (1000 BTU/cf Gas)	7,350	7,787	8,220	8,646	9,068	33,721
3.	Block 1 (Old) Gas, Bcf (1000 BTU/cf Gas)	4,150	3,943	3,745	3,558	3,380	14,626
4.	TOTAL Block 1 + Block 2 volume, (Bcf (1000 BTU/cf Gas)	11,500	11,730	11,965	12,204	12,448	48,347
5.	Block 2, Decimal Fraction (L.2/L.4)	.639	.664	.687	.708	.728	.697
6.	Block 1, Decimal Fraction (L.3/L.4)	.361	.336	.313	.292	.272	.303
7.	I. Continue with Rolled-in Pricing, Block 1 Stays Regulated						
8.	Prices: New gas - Continue w/Rolled-in Pricing-some decline	$ 3.60	$ 3.40	$ 3.20	$ 3.10	$ 3.00	
9.	Old gas - Continue as is - Remains Regulated	1.46	1.52	1.59	1.66	1.73	
10.	WACOG: New gas - Component, (L.5 X L.8), $/MMBTU	2.30	2.26	2.20	2.19	2.18	
11.	Old Gas - Component, (L.6 X L.9), $/MMBTU	.53	.51	.50	.48	.47	
12.	WACOG: Average Price (L.10 + L.11), $/MMBTU	2.83	2.77	2.70	2.67	2.65	
13.							
14.	Market Clearing Price Forecast-$/MMBTU	$ 2.50	$ 2.40	$ 2.39	$ 2.60	$ 2.77	
15.	Revenue, New gas (L.2 X L.8) - MM$	26,460	26,476	26,304	26,803	27,204	106,787
16.	Revenue, Old gas (L.3 X L.9) - MM$	6,059	5,993	5,955	5,906	5,847	23,701
17.	Revenue-TOTAL, Rolled-in Pricing (L.15 + L.16)-MM$	32,519	32,469	32,259	32,709	33,051	130,488
18.	II. W/NOPR, Block Billing, Block 1 Remains Regulated						
19.	Prices: Block 2; 2 Yr. Decline to Market	$ 3.60	$ 2.93	$ 2.39	$ 2.60	$ 2.77	
20.	Revenue: Block 2 - (L.2 X L.19) - MM$	26,460	22,816	19,646	22,480	25,118	90,060
21.	Block 1 - (L.3 X L.9) - MM$	6,059	5,993	5,955	5,906	5,847	23,701
22.	TOTAL, Blocks 1 & 2 (L.21+L.22) - MM$	32,519	28,809	25,601	28,386	30,965	113,761
23.	Decline in Block 2 Revenue, II. VS. I. (L.17-L.22),MM$	0	-3,660	-6,658	-4,323	-2,086	-16,727
24.	III.W/NOPR-Block Billing W/2 Yr Phase-Up of Blk 1 to Mkt.						
25.	Prices: Block 1, 2 Yr Phase-Up to Mkt-$/MMBTU	$ 1.46	$ 1.87	$ 2.39	$ 2.60	$ 2.77	
26.	Revenue: Block 1-2 Yr Phase-Up to Mkt. (L.3 X L.25), MM$	6,059	7,373	8,951	9,251	9,363	34,938
27.	Revenue: Gain for Block 1 (L.26-L.21 or L.16)	0	+1,380	+2,996	+3,345	+3,516	+11,237
28.	Revenue: Block 1 Gain Less Block 2 Loss (L.27-L.23), MM$		-2,280	-3,662	- 978	+1,430	-5,490

SCHEDULE 3

BLOCK 1 & 2 VOLUME PROJECTIONS-INTERSTATE
NEXT FOUR YEARS BCF/YEAR (OF 1,000 BTU/CF GAS)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
	BLOCK 2 (NEW GAS - BCF/YR (MBTU/CF GAS) OR 10^6 MMBTU						Block 1				
		Prod. from Res.Adds. of 10Tcf/Yr @ 1/20									
Year	5% Decline Per Year	1986	1987	1988	1989	Block 2 U.S. W/ Res Adds.	(Old) Gas 5%/yr Decline	Blks. 1&2 Production U.S. Only Col. (6)+(7)	Interstate Demand 2%/Yr.Incr.	Net Imports Required to Meet Demand Col. (9)-(8)	Block 2 Including Imports Col. (6)+(10)
1985	6430					6430	4150	10580	11500	920	7350
1986	6109	500				6609	3943	10552	11730	1178	7787
1987	5803	500	500			6803	3745	10548	11965	1417	8220
1988	5513	500	500	500		7013	3558	10571	12204	1633	8645
1989	5237	500	500	500	500	7237	3380	10617	12448	1831	9068

Senator NICKLES. Thank you very much, Mr. Tell.
Mr. Russell.

STATEMENT OF DONALD G. RUSSELL, VICE PRESIDENT, PRODUCTION, SHELL OIL CO.

Mr. RUSSELL. Thank you, Mr. Chairman. Members of the subcommittee, my name is Don Russell. I am vice president of production for Shell Oil Co. and I am responsible for the production and marketing of natural gas by Shell and its affiliates in the United States.

My purpose here today is to give you Shell's reaction to the notice of proposed rulemaking issued by the Federal Energy Regulatory Commission. The subcommittee is already very familiar with the terms of the NOPR, so I won't repeat them here. First I would like to respond to the subcommittee's four questions and then to amplify my response by a discussion of the basic principles which Shell has utilized in evaluating the NOPR.

First of all, Shell does not believe that the NOPR would create a regulatory system which would be operationally workable and legally sound. Shell believes that the proposal would have an adverse effect upon exploration for new gas supplies and production from existing gas reserves, and thus would not assure a reliable long-term supply of natural gas at the lowest possible cost.

At the same time, however, Shell does not believe that the public interest would be better served by retaining the existing regulatory system. In particular, Shell believes that the NOPR provides an improvement in the FERC transportation regulations. The existing regulatory system does not provide an efficient method to permit direct sales from producer to consumer. Even the tentative steps taken in this direction by the Commission have been vacated by the D.C. Court of Appeals, effective next month. So something must be done.

Shell has approached the NOPR on the basis of three principles. First of all, the rule should facilitate the transportation of shipper-owned gas by pipelines without discrimination between buyers, sellers, markets or categories of gas and with a minimum of red tape. Second, the rules should not require, directly or indirectly, the abrogation or amendment of valid contracts without the consent of both parties. Third, the rules should not reduce the supply of gas available to the consumer. In particular, it should not waste the old gas supplies already connected to the interstate pipeline system.

Applying these principles, Shell believes that the sections of the proposal which provide for non-discriminatory transportation of shipper-owned gas are in the public interest. I would like to make clear, however, that in supporting the transportation sections of the NOPR Shell is very much opposed to the section which authorizes firm customers of pipeline companies to reduce their contract demand arbitrarily by a maximum of 25-percent per year.

This brings me to my second principle, the sanctity of contracts. I believe it is bad public policy for the Commission to abrogate or change contracts between two private parties, and this goes for contracts at both ends of the pipeline.

I saved my most important point for last. The block pricing provisions of the NOPR are the wrong answer to a serious problem—how to make the hopeless mishmash of prices in the NGPA compatible with market conditions. Shell believes that block pricing would be unfortunate for the producing industry.

It simply perpetuates the present complex and inadequate system in another form and we believe will ultimately result in the return of gas shortages. It represents an abject failure by the Commission to exercise its authority to raise prices on old gas where the public interest requires it. Failure to raise old gas prices will result in the certain waste of trillions of cubic feet of gas in known developed fields. Gas abandoned in the ground is wasted just as surely as if it were flared.

Unless the Commission solves the old gas problem by raising the ceiling rates, Shell believes that this committee should immediately accelerate consideration of S. 1302, introduced by Senator Nickles. This bill, which provides for the gradual phasing out of old gas controls as contracts expire, addresses the problem of the price cushion and the market distortions which result from it.

The point I wish to hammer home, however, is that it will save the American consumer some 31 to 37 trillion cubic feet of gas which otherwise would be left in the ground and wasted, and this gas is already connected to the transportation network. Gentlemen, we're talking about 2 years of supply for the United States.

To document these volumes, Shell has updated the study prepared by Dr. C.S. Matthews for the Sharp subcommittee 2 years ago, and we have addressed it directly to the impact of S. 1302 on gas supply. In my written statement the details of the study are spelled out.

To sum up, we believe that nondiscriminatory access to the pipeline transportation network as provided in the NOPR, coupled with a phaseout of price controls on old gas, as provided in S. 1302, would allow all natural gas supplies to compete within the market on the basis of economics rather than artificial advantages gained through regulation and will avoid the tragic waste of a finite and precious resource. All things considered, we believe this combination gives the nation the brightest hope of avoiding the surplus-shortage cycle of the past.

Thank you very much for the opportunity to make this statement.

[The prepared statement of Mr. Russell follows:]

STATEMENT OF DONALD G. RUSSELL
VICE PRESIDENT - PRODUCTION
OF SHELL OIL COMPANY
BEFORE THE SUBCOMMITTEE ON ENERGY
REGULATION AND CONSERVATION OF THE
SENATE ENERGY COMMITTEE
SEPTEMBER 19, 1985

My name is Donald G. Russell. I am Vice President of Production of Shell Oil Company, and am responsible for the production and marketing of natural gas by Shell and its affiliated companies. I appreciate the opportunity to discuss with you Shell's position on the Notice of Proposed Rulemaking (NOPR) issued by the Federal Energy Regulatory Commission (Commission) in Docket No. RM85-1-000, and the interrelationship between this regulatory action and S. 1302, introduced by Senator Nickles.

In the storm of criticism that has arisen against the NOPR, we should not forget that the Commission was attempting to respond to a real problem which has developed in the gas industry as a result of continuing price controls over old gas, and a "vintage" pricing system under such controls which dictated a wide range of prices for an identical commodity, natural gas, in total disregard of the market impact of such prices, and in total disregard of the fact that the supply of old gas is critically price responsive.

This vintage pricing system was designed to subsidize prices for higher-cost, or "new" gas, by holding the price for "old" gas below market levels. Thus, pipelines were permitted and encouraged to pay above market prices for new gas, while still retaining a market price for its overall supplies by "rolling in" or averaging, all of the prices which it paid for natural gas. Since 1982, pipeline purchases at the wellhead have reflected market considerations even as to high-cost gas, despite rolled-in pricing. It is now popular to criticize pipelines and producers for entering into high-priced contracts for high-cost gas, and to attempt to pressure them into renegotiating these contracts. So far these attempts have stopped short of contract abrogation, but such action is being actively urged on both the Congress and the Commission.

Those who criticize the industry for such contracts would do well to remember that they are but the mirror image of the regulatory system imposed on gas prices by the Natural Gas Policy Act (NGPA). Such distortions in the gas market will continue as long as old gas is forced by law to be sold at below market prices. The real tragedy is that old gas will be left in the ground and wasted if nothing is done about raising old gas prices to market levels.

Removal of price controls from roughly half of the natural gas flowing in this country on January 1, 1985 has created new opportunities for gas prices to respond to market forces. The result of this decontrol has not been a price "fly-up", as those who erroneously assert that the gas industry is monopolistic had predicted, but instead a continual downward pressure on gas prices due to supply and demand factors.

It has been widely recognized however, by both the industry and the Commission, that the existing system of pipeline regulation was impeding, and in many cases preventing, the operation of these market factors. Pipeline regulation had "grown like Topsy" over a period of almost 50 years into a complex snarl of red tape comprehensible only to the Commission Staff and the pipelines themselves. Through cost-of-service regulation, which guaranteed the pipelines not only cost recovery but an assured profit, the pipelines have largely been able to maintain, and even increase, their "margin," or share, of the consumers' dollar, at the expense both of the captive consumers and the captive producers, who have no place else to sell their gas. Thus, during the surplus market of 1983 and 1984 the average annual increase for residential prices was almost 9.0 percent whereas the average wellhead price increased less than 3 percent. Further statistics illustrating these facts have been developed by the Department of Energy and the Natural Gas Supply Association.

Due to the loss of markets, primarily industrial markets, by interstate pipelines, surplus capacity on an off-peak basis became available in most major pipeline systems. Distribution companies and industrial customers sought to purchase gas directly from producers whose wells were shut-in by the pipelines. Even though both the customer and the producer were willing and able to complete such purchases, they were prevented from doing so by restrictive Commission regulation, and an unwillingness on the part of the transporting pipelines to transport gas which would compete with their own markets. Led by Senator Bradley, this Committee attempted to draft legislation to solve the problem, and included it in S. 1715, which failed to pass the full Senate. The Commission made several modest, and heavily restricted attempts to encourage direct sales through Order No. 234-B and the Special Marketing Programs, which were overturned by the D.C. Circuit in the Maryland People's

Counsel cases, not because they were too bold, but because they did not go far enough in the direction of non-discriminatory transportation by pipelines.

In the NOPR, the Commission has proposed a basic and far-reaching revision of its pipeline regulation of direct sale gas. The Commission now proposes to grant pipelines blanket certificates to transport shipper-owned gas without restrictions as to class of customer, categories of gas, or price or volume of the gas transported. Flexibility is given the pipeline to negotiate transportation rates on a volumetric and mileage basis within a "zone of reasonableness." The pipelines are required to "unbundle" their rate structures, so that the shipper is required to pay only for the services which he receives.

Although a number of questions remain, such as how the vacant capacity of a pipeline is to be allocated, and what modifications may be required to make the general regulations fit the operational characteristics of particular pipeline systems, Shell believes that the transportation sections of the NOPR provide a sound basic framework for transportation of shipper-owned gas. Therefore, Shell believes that this portion of the NOPR should be finalized as soon as possible. As the Order Nos. 234-B and 234-C procedures and the Special Marketing Programs expire on October 31, 1985, the Commission should make every effort to put the transportation sections of the NOPR in place by that date.

One aspect of the transportation program in the NOPR is disturbing to Shell. This is the provision that a distribution company shall have the right, at its option, to reduce its firm demand by 25 percent in a calendar year, which would apparently permit such distribution company to unilaterally abrogate or alter its contract with its pipeline supplier. While it might be economically desirable (or undesirable, depending on a party's viewpoint) to grant distribution companies the freedom to seek alternate gas supplies as opposed to purchasing them exclusively from their traditional pipeline supplier, Shell does not believe the distributor should be given the power to arbitrarily breach his contract with the pipeline to achieve such a result.

In similar fashion, pipelines and distribution companies are urging the Commission to authorize them to unilaterally breach their contracts to purchase gas from producers, by invalidating, either directly by administrative fiat or indirectly by imposing a condition to a producer's participation in otherwise "non-discriminatory" transportation, the take-or-pay provisions in producer contracts. In both instances, there are significant legal questions raised whether the Commission has the power to abrogate these contracts. Such attempts are certain to lead to prolonged judicial review with uncertain results, which would impair the full implementation of the transportation programs for many years.

Aside from legal objections, Shell does not believe it is good public policy to abrogate, or allow one party to abrogate, contracts entered into in good faith merely because market circumstances have changed. Should this practice become public policy, Shell will certainly have the utmost reluctance to enter into long-term gas sales contracts, no matter what assurances are given by the Commission that such policy will not apply to _future_ contracts. Shell has had to deliver gas under older contracts at low prices for many years, and is still doing so today. Where the weighted average price of all gas delivered to a particular pipeline by Shell is _less than_ that pipeline's weighted average cost of gas (WACOG), Shell does not believe that it should be required to reduce the price or takes of the higher-priced contracts with that pipeline to reduce its weighted average price even further, so that high-priced gas produced by others will be marketable.

Where Shell's weighted average price to a pipeline is higher than the pipeline's WACOG, Shell has been willing to renegotiate prices and reduce take provisions. In addition, Shell has, as a matter of policy, waived many take-or-pay payments in its existing contracts for certain time periods, and has settled outstanding take-or-pay payments for fractions of the amounts owed to Shell by pipelines under our contracts.

Shell believes that the NOPR attempts to further this settlement process, and therefore, is proceeding in the right direction. However, by putting arbitrary limits on the amounts which a pipeline can pay, and arbitrary restrictions on what the contracts must contain after the negotiations are completed, the NOPR operates to reduce the flexibility of such negotiations. If the Commission were to make clear that a pipeline could "buy out" problem contracts by purchasing from the producer a total cancellation of the contract with a release of obligations on both sides, coupled with the availability of transportation to new buyers and automatic abandonment authority from the Commission where needed, and be assured of "flow through" of the buy-out payments where the normal prudence standards are met, the so-called "take-or-pay problem" could be resolved by the parties to the contracts.

As I noted at the outset of this Statement, the chaotic price structure of natural gas is a direct consequence of the vintage pricing structure imposed on the industry by the NGPA, and the earlier ceiling prices established by the Commission under the Natural Gas Act (NGA). The Commission addresses this problem in the NOPR by the so-called "Block Billing" or "Block Pricing" proposal. This proposal allocates gas into two basic categories: The first category consisting of gas covered by Sections 104, 106(a) and 109 of the NGPA, and the second category consisting of all other gas. (Block 3 consists of relatively minor charges which will be allocated between Blocks 1 and 2 in some way yet to be determined). Block 1 gas, which consists only of the lowest-price categories for forever-controlled gas, is then set aside for the benefit of a favored class of consumers. Rolled-in pricing, which has been used by the pipelines for 50 years to average their gas costs from various sources, is abolished, without any hearing or findings that this pricing system is no longer just and reasonable. The distribution company may utilize its valuable "entitlement" to cheap, forever-controlled gas as a marketing tool to outbid other purchasers for supplies of new gas, as the pipelines used their NGPA "gas cushions" in the late 1970's. Alternatively, these Block 1 prices can be rolled-in at the distributor level to artificially reduce the consumer's prices below the market value of new gas. Thus, the consumer receives a false "market signal" that gas is plentiful and cheap -- similar to the false signals he received in the 1960's and early 1970's which led to the shortages of the late 1970's.

Pipelines have testified before the Commission and this Subcommittee that the Block 2 gas under the NOPR will be unmarketable, because it exceeds the cost of alternate fuels in many markets. This may cause the following things to happen:

1. The price of Block 2 gas will be driven down by market pressures. This will reduce the producer prices on high-cost gas and new gas to market levels. Block 1 gas will continue to be sold below market levels due to price controls. The result will be a false market signal to both producers and consumers.

Residential consumers will increase their demand for gas in response to this false signal. The reduction in price will in turn reduce exploration and development of new gas supplies, leading in a few years to renewed shortages of gas.

2. Consumers who do not qualify for Block 1 prices, particularly industrial consumers will shift to alternate fuels, further decreasing the industrial demand for gas and increasing the price of gas to the residential consumer, because he will be required to bear a larger share of the fixed costs of transporting and distributing the gas.

The net result is that the residential consumer ultimately will pay more for his gas.

Worst of all, the Block Pricing proposal does nothing to resolve the basic problem on Block 1 gas, which is the depression of prices of this category of gas below market values. Instead, a constituency of specially privileged consumers is created, who will defend to the death their "entitlement" to cheap controlled gas as the valuable property right which it has become, all by governmental fiat with no connection to costs or market values. The scramble to be included in this favored class by amending or changing the definitions has already begun before the Commission.

The Commission has the power, granted it by Congress in the NGPA, to raise old gas prices to market levels. We urge you Senators to use your influence to persuade the Commission to sever the Block Pricing provisions from the rest of the NOPR and take further comments or evidence on eliminating the price cushion, rather than shifting it from pipelines to distributors, by raising old gas prices to market levels. The Commission instituted such a proceeding in 1982 (Docket No. RM82-26), but abandoned it when it appeared that Congress was prepared to enact additional gas legislation phasing out price controls. Evidence submitted in that proceeding by producers utilizing the costing methods approved by the Commission in the National Rate Cases established that the just and reasonable rate for old gas exceeds what the market will pay for it today. Indeed, the ceiling price for the highest-price category of old Section 104 gas is $2.50 per MMBtu, which exceeds the market price in many parts of the country. Therefore, the transition of old gas prices from controlled levels to market levels would not be as traumatic as it would have been just two years ago.

The Commission has the power under the NGPA to raise old gas prices where such increases are determined to be just and reasonable. A hearing should be held where such a determination can be made.

Whether or not the Commission persists in the Block Pricing approach, we believe that it is essential for the Congress to take action. Fortunately, a vehicle for this action is already before you.

S. 1302, sponsored by Senator Nickles, provides a phased, gradual approach to decontrol of old gas prices which minimizes the market impact while gradually eliminating the distortions created by the vintage pricing system, and at the same time preserving contract rights, a principle which we believe is so important in government actions affecting the gas industry, as well as many other areas of the economy which rely on contract stability, such as the banking and insurance industries.

When confronted with the alternative of Block Pricing, we believe that much of the opposition to gradual removal of price controls on old gas will disappear.

Two years ago I testified before the Subcommittee on Fossil and Synthetic Fuels of the House Committee on Energy and Commerce. At that time I presented a study by Dr. C. S. Matthews, a Shell Senior Petroleum Engineering Consultant, in which he estimated how much old gas reserves would increase if old gas were deregulated. I have asked Dr. Matthews to prepare a similar study to estimate how much gas reserves would increase if S. 1302 were enacted. This study is attached as Appendix A.

For an average market clearing price for gas over the next decade of $3.00 per MMBtu (in 1985 dollars), the study indicates that enactment of S. 1302 would add between 31 and 37 Tcf to U.S. gas reserves. This is about two years U.S. gas production. These reserves would be added in three ways. First, an increased gas price on contract expiry would enable the lowering of abandonment pressure in old gas fields. At a higher gas price the wells in that field can be produced to a lower producing rate before revenue is equal to producing cost. Thus, the field will reach a lower pressure which will result in additional gas being produced.

The second method by which reserves will be added as a result of S. 1302 is due to additional well stimulation.

Fracturing and acidizing of old wells opens new pay zones and enhances the contribution of zones of low productivity. At low regulated gas prices, this stimulation is usually uneconomic and will not be carried out. However, as contracts expire and the price for gas rises, many well stimulation treatments become profitable and will be undertaken.

We estimate that the combined effect of lowering of abandonment pressure and additional well stimulation due to deregulation on contract expiry could add from 20 to 26 Tcf to U.S. gas reserves at a $3.00 per MMBtu market price.

The price currently allowed by the NGPA for onshore infill wells ($3.02 per MMBtu) is about the same as our assumed average market clearing price over the next decade ($3.00). Thus, enactment of S. 1302 will cause no additional infill drilling in old gas fields at this time. We should keep in mind, however, that the $3.02 NGPA price is frozen forever in real terms. Enactment of S. 1302 will lead to additional infill drilling when gas prices rise above the $3.02 per MMBtu price (in 1985 dollars). Our $3.00 per MMBtu average price for the next decade assumes a price somewhat less than $3.00 for the initial five years and somewhat greater for the last five years. Thus, S. 1302 would have a positive effect on infill drilling in the 1990's.

We have estimated in Appendix A that the potential reserves due to infill drilling at prices above $3.02 per MMBtu (in 1985 dollars) will be about 11 Tcf.

Thus, the total additional reserve additions due to enactment of S. 1302 range from 31 to 37 Tcf.

The gas industry today faces two basic and far-reaching problems in establishing a rational, supply-demand-driven market for its product.

The first problem is the need to provide open access to the pipeline transportation network on a non-discriminatory basis. We believe the NOPR will accomplish this, with the assistance and constructive ideas of all sections of the industry.

The second problem is the multi-vintage pricing structure forced on the industry by the NGPA, the so-called cushion problem. The Block Pricing scheme of the NOPR does not solve this problem; it exacerbates it. Therefore, Congress should act to pass S. 1302, to phase-out old gas price controls as contracts expire, gradually eliminating the problem over a reasonable time period.

Non-discriminatory access to the pipeline transportation network as provided in the NOPR coupled with the phase-out of price controls on old gas provided in S. 1302 will allow all natural gas supplies to compete within the market on the basis of true economics rather than artificial advantages gained through regulation. This will benefit all consumers by providing very substantial additional supplies of gas from existing old fields at a lesser cost than searching for undiscovered reserves. This will prevent waste of an irreplaceable, precious natural resource. The removal of transportation roadblocks will encourage the establishment of new markets and greater pipeline throughput which will also act to reduce unit transportation costs which will particularly benefit domestic consumers.

APPENDIX A

Increase in U.S. "Old Gas" Reserves Due to Enactment of S. 1302

The treatment here follows that given in the April 1983 study entitled "Increase in United States 'Old Gas' Reserves Due to Deregulation," by C. S. Matthews, Shell Oil Company. That study was submitted in April 1983 to the U.S. House of Representatives Subcommittee on Fossil and Synthetic Fuels of the Committee on Energy and Commerce.

In the April 1983 report, we estimated that reserves of old gas in the lower 48 states which would respond to deregulation were about 115 Tcf as of January 1, 1981. At that time we included 30.8 Tcf of intrastate gas in the 115 Tcf. We did this because, even after the so-called deregulation of much of intrastate gas on January 1, 1985, an additional price limit was placed on this deregulated gas. In our April 1983 study this price limit was less than our assumed market clearing price. Thus, this gas was really not price deregulated under those market conditions.

Under current market conditions, we find that the price limit placed on this deregulated intrastate gas is greater than the current market clearing price. Thus, we should subtract from 115 Tcf, the reserves of intrastate gas which were deregulated on January 1, 1985. We estimate that about 73 percent of intrastate gas was deregulated at that time. Therefore, we subtract .73 (30.8) = 22.5 Tcf from 115 Tcf and obtain 92.5 Tcf as the base responsive to decontrol.

The calculations shown in Table 1 of the cited report are now repeated for a deregulated price over the next decade of $3.00 per MMBtu. This leads to an increase in reserves due to lower abandonment pressure for the 14 fields in Table 1 of 9 Tcf. We scale this up to the total U.S. by multiplying by 92.5/41.3 where 41.3 is the reserve for the 14 fields and 92.5 is the total responsive reserve base of old gas in the United States as of January 1, 1981. This gives 20 Tcf as the estimated increase in old gas reserves due to lower abandonment pressure at the $3.00 per MMBtu price.

We estimate the increase in reserves due to fracturing and acidizing as 1.5 percent of ultimate as discussed on page 18 of the cited report. For the response base of 92.5 Tcf, the ultimate is 92.5 (475)/115 = 382 Tcf. Thus, the fracturing and acidizing increase is 0.015 (382) = 6 Tcf.

The total possible response is 20 + 6 = 26 Tcf.

In applying these calculations to S. 1302, we estimate that about 10 percent of old gas contracts with expiry dates will expire each year. S. 1302 also contemplates relief for those contracts which will not expire soon enough to achieve deregulated price relief -- even those contracts having a term for the life of the lease or the reserves. Proposed section (f)(2) would allow the parties to renegotiate contracts to bilaterally increase price to levels sufficient to continue economic production. Thus, within the next decade nearly all old gas contracts will expire or can be renegotiated to continue economic production. In this time frame, we estimate that no significant number of fields will be abandoned. Although some wells in a field may be abandoned, the remainder still producing at contract expiry can be produced to the new lower reservoir abandonment pressure and thereby increase gas recovery from these fields. The maximum increase for the U.S. is estimated above to be 20 Tcf.

Fracturing and acidizing would also be undertaken on contract expiry. In addition to enhancing productivity of old wells, this in many cases would open new pay zones and increase production from low productivity layers. This would lead to the estimated 1.5 percent increase in ultimate production from the wells (6 Tcf). As some wells will be abandoned before contract expiry, the 6 Tcf should be viewed as a maximum.

In summary, we estimate that the combined effect of lowering of abandonment pressure and additional well stimulation due to enactment of S. 1302 will increase U.S. "old gas" reserves by 20 to 26 Tcf.

Thus far we have not have not addressed infill drilling. Enactment of S. 1302 would not lead to additional infill drilling at this time. This is because the current price allowed by the NGPA for regulated onshore infill wells ($3.02 per MMBtu) is about the same as our assumed market clearing price over the next decade ($3.00 per MMBtu in 1985 dollars). However, we must keep in mind that the NGPA price of $3.02 is frozen forever in real terms. It rises only with inflation. Thus, enactment of S. 1302 would have a positive effect on infill drilling when gas prices rise above $3.02 per MMBtu (in 1985 dollars). Our $3.00 per MMBtu average price for the next decade assumes a price somewhat less than $3.00 for the initial five years and somewhat greater for the last five years. Thus, S. 1302 would have a positive effect on infill drilling in the 1990's.

To estimate how much such infilling would add to "old gas" reserves, we refer to the section on infill drilling in our cited April 1983 report. Because additional infill drilling would not occur for some time, we eliminated fields where the gas reserve was less than 20 percent of ultimate recovery in 1981. This eliminated Puckett, Carthage, Kettleman Hills and Rio Vista. We also eliminated the high-cost infill fields, Bayou Sale, Bastian Bay, Katy and Old Ocean reasoning that infilling would only occur well into the future. By so doing we eliminate 18 percent of the infill potential of the Analog Fields in Table 1.

Our previously-calculated infill reserve addition for the total U.S. was 18 Tcf, using a response base of 115 Tcf. For our revised response base of 92.5 Tcf, the potential U.S. reserve additions are 14.5 Tcf. If we assume for reasons stated above that we will obtain only 82 percent of this potential, our estimate becomes 12 Tcf.

Of this 12 Tcf potential, infill wells not drilled on acreage committed or dedicated to interstate commerce on April 20, 1977 where either decontrolled on January 1, 1985 or will be decontrolled on July 1, 1987. We can estimate the magnitude of this from information in Table 12 of "U.S. Crude Oil and Natural Gas Reserves," 1977 Annual Report by the U.S.

Department of Energy. That Table indicates that about 5 percent of gas reserves in the lower 48 states were not committed as of December 31, 1977. Thus, 5 percent should be subtracted from the 12 Tcf potential due to decontrol in the above-mentioned categories. This brings our final estimate to 11 Tcf due to additional infilling brought about by S. 1302.

Thus, the total potential reserve additions due to the enactment of S. 1302 are 31 to 37 Tcf.

Senator NICKLES. Mr. Russell, thank you very much. Dr. Eck.

STATEMENT OF DR. THEODORE R. ECK, CHIEF ECONOMIST, AMOCO CORP.

Dr. ECK. My name is Ted Eck. I am chief economist of Amoco Petroleum Co. We, of course, are a very large producer of gas but particularly heavily committed to the task of exploring for gas. We are very concerned about the impact of this proposed NOPR on our continued ability to explore for gas.

Indeed, we believe that most of the proposed regulations are misguided and will adversely impact the long-term domestic gas supply. You have heard the testimony of the other panelists reflecting on the legal flaws in the NOPR and, frankly, I have concluded that the first stop of the NOPR is going to be the courthouse, and that's where it's going to stay for 2 or 3 years.

During this period of time we simply aren't going to be able to sign long-term contracts and they are not going to be able to be concluded because neither the buyer nor the seller are going to know if those contracts are enforceable. This is going to lead to a period of sharply reduced exploration activity.

The basic underlying economic flaw in the NOPR is the assumption that the problem facing the gas business is an excess of supply. We are convinced that in the absence of the NOPR we are facing a supply shortage and we have concluded that 10 years from now the United States is going to be very hard-pressed just to meet basic demands, basic requirements for natural gas—and that's even after importing all the gas that we think is available in Mexico and in Canada.

Now, if we overlay on top of this a gas shortage condition the NOPR, we are convinced the net effect of this is going to be gas curtailments, a shift back from natural gas burning to oil imports. In fact, our judgment is, based upon our modeling effort, that oil imports will be 1 million barrels a day higher 10 years after the enforcement of the NOPR, and in a period like today when we are all concerned about the balance of trade, balance of payments, it certainly is misguided policy to assure that we're going to have to spend billions of additional dollars to support oil imports.

As indicated, the problems facing this industry are supply, not markets. The markets for natural gas are highly competitive, prices are going down, contracts are being renegotiated. The price of gas is already only half—at the wellhead half the price of crude oil. The wellhead price of gas is only about a third of the delivered cost of gas to most residential consumers.

Gas is the cheapest fuel, cheapest industrial fuel in virtually every market of the United States. The only impact of lower gas prices will be to shut additional volumes of coal in the ground. We have already lost whatever residual fuel, whatever additional fuel-shifting capacity exists from oil to gas. Gas has backed out all that oil. Indeed, what's going on right now is most of the additional electric power generation capacity in the United States that's going in is gas-fired, not coal-fired, because of cheap natural gas.

We agree with the other panelists that the open transportation provisions in NOPR are directionally good, although we should caution that this is on the interstate transportation and doesn't directly address the problem of access to the local distribution company pipelines.

We concur that the most serious flaws in the NOPR are the block billing and the take-or-pay safe harbor and the other provisions relating to ability to cancel contracts. My specific concern with the block billing is it's going to make it impossible to conclude new long-term supply agreements, that forcing down the price of gas is going to mitigate this process.

Now a lot of people will say well, this is not a problem. We're just going to go to a spot marketing system; we don't need contracts. I don't believe that for 1 minute. I don't believe that the municipalities in this country, the industrial users of natural gas are going to be satisfied to rely on spot markets to meet their core requirements.

If we look at the coal industry, the coal industry has legal permissibility to use spot contracts, spot markets and contracts. Most coal is delivered under contract. If we look at the oil business, although we have spot contracts most refiners rely on long-term supply agreements, not on spot markets, to meet their requirements. There is just no basis to suggest that spot markets are going to solve the supply reliability requirements needed in the natural gas business.

It has been admitted by the FERC that the block billing procedure would lower the price of natural gas. There's no question that this would take place and would certainly result in increased demands for gas, with more seriously, of course, a cut in supply. Now some economists would say well, that's fine. That's the way markets should work. We're going to force down prices, but in this case an artificial forcing down of prices; when there's a shortage then prices will come up and then the problem will go away.

The problem in this industry, though, is the very long lead times in getting the supply mechanism back in place. After we have laid off the rigs and laid off the workers and quit drilling the wells, we're talking about lead times of 5 to 10 years, and that's what I'm really concerned about. We have a mechanism that's going to eliminate the inventory of known gas reserves, but there is no provision for replacement of those reserves once this liquidation takes place.

It has been attested that if there is a problem in the marketplace, it's a problem of old gas and we thoroughly agree that this should be addressed by congressional actions such as S. 1302 and not by these legally flawed gimmickry approaches suggested in the NOPR.

Indeed, there are so many defects in the NOPR that we believe these cannot be cured by minor revisions in the text disclaimers as to legality and so on and it is imperative indeed that we proceed by severing the transportation portion of the NOPR, permitting that to go into effect, and indeed we urge the members of this committee to insist that FERC not implement the nontransportation proposals and leave the task of writing new rules governing the sale of natural gas to the Congress to ensure that they are reasonable and also legal and enforceable.

Thank you.

[The prepared statement of Dr. Eck follows:]

TESTIMONY ON THE FEDERAL ENERGY REGULATORY COMMISSION'S NOTICE OF PROPOSED RULEMAKING (RM85-1)

BY

THEODORE R. ECK

CHIEF ECONOMIST

AMOCO CORPORATION

BEFORE THE

U.S. SENATE ENERGY REGULATORY AND

CONSERVATION SUBCOMMITTEE

SEPTEMBER 19, 1985

SUMMARY

The Federal Energy Regulatory Commission (FERC) in its Notice of Proposed Rulemaking (NOPR), RM85-1-000, has proposed new regulations to restructure natural gas markets. Amoco believes that many of the proposed regulations are misguided and adoption would adversely impact the long-term supply of U.S. natural gas. Additionally, other producers, pipelines and industrial users have indicated that a large part of what has been proposed would be unfavorable to the natural gas industry.

The proposal sets out lofty goals that few would disagree with, and has structured a complex theoretical system for achieving these goals that on first reading sounds quite plausible. However, upon a more thorough examination the practical and legal problems become increasingly apparent, and even from a theoretical viewpoint the proposal cannot lead to the stated goals. Some of the key features of the regulations are, at best, of dubious legality and if implemented would undoubtedly be challenged in the courts, resulting in a prolonged period of uncertainty.

The long-term outlook for U.S. natural gas supply is already unfavorable, with natural gas proved reserves down to about half the 1967 level, the rig count off nearly 60 percent from its peak in 1981, and gas well completions declining. In 1984 the U.S. petroleum industry replaced only 84 percent of the natural gas reserves produced. Unless there is a meaningful increase in the replacement rate, the current surplus of producing capacity will eventually give way to a natural gas shortage. The added disruption that would be caused by the proposed regulatory overhaul would bring closer the day when supply will not be adequate.

The natural gas markets have already come a long way in sorting out pricing and contract problems. Gas prices have been declining and are already at or below the competitive level compared with oil prices. Take-or-pay problems have been settled or are being negotiated. However, most participants in the natural gas markets agree that there is a need to open up transportation for gas which is the intent of the proposed regulations. The problem with the NOPR is that it goes beyond what is needed and creates a large number of inefficiencies in the process.

FERC feels pressured by the November 1 deadline of the D.C. Court to eliminate the discriminatory feature in two of their transportation programs. But to subject the entire industry restructuring program to this deadline does not make sense. If FERC feels it is essential to keep these two programs going beyond the November 1 deadline, then they should be altered to correct the legal defects identified by the court.

The NOPR contains not only a complex transportation proposal but also includes other areas that would cause harm and complications. Three provisions are extraneous to implementing open transportation:

(1) block billing,

(2) take-or-pay safe harbor, and

(3) the unilateral right of firm customers to abrogate contracts.

These extraneous features have serious legal and policy defects which cannot be cured and will prevent the early implementation of open transportation. To meet the November 1 deadline, it is imperative that the transportation issue be separated from the other changes that have dubious legality and could tie up the entire rulemaking in the courts for years. Few would disagree that much more time and attention is needed to correct the multitude of legal, practical, and theoretical problems identified in the 7,000 pages of comments and two days of public comments. This need for more time and review should not be cut off just to comply with a time restraint on a couple of programs that can be handled separately.

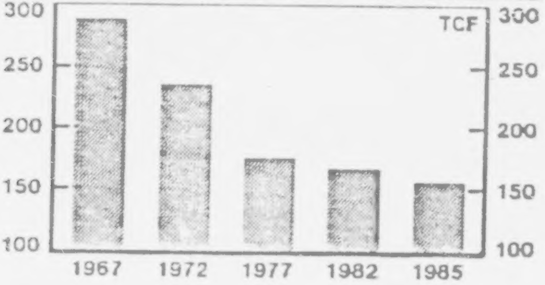
If the non-transportation proposals of NOPR are implemented, they would have
the impact of major new gas legislation on the natural gas markets. We esti-
mate that as a result of NOPR, U.S. gas production would decline and gas
imports would have to increase by an additional 3 trillion cubic feet per year
(from 3 TCF to 6 TCF per year) by 2000 in order to meet demand. Therefore, it
is important that the Congress thoroughly review these proposals before they
are implemented.

The delinking of the transportation issue from all other features of the NOPR
would allow Congress and industry the needed time for a proper review of the
NOPR and its impact on the natural gas industry. We urge the members of this
Subcommittee and other members of Congress to insist that FERC not implement
the non-transportation proposals until there has been time for such a review.

U.S. NATURAL GAS SUPPLY AND DEMAND

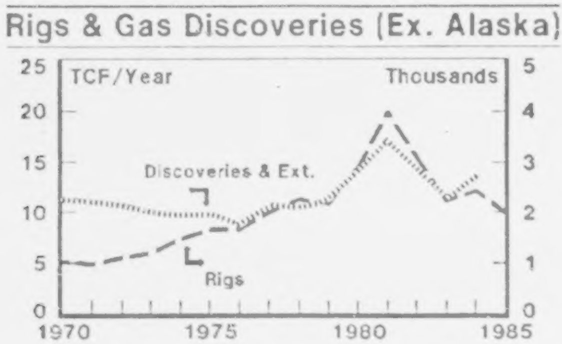
A major challenge to the U.S. is to limit our dependence on imported oil and natural gas for both national security and economic reasons. However, the U.S. petroleum industry is once again investing at a level well below that needed to maintain natural gas production. The number of U.S. drilling rigs operating has already fallen from 4,500 in 1981 to about 2,000 today. The Federal Energy Regulatory Commission has proposed regulations that would further reduce the long-term production of natural gas.

We believe that the current excess gas producing capacity, the so-called gas bubble, is temporary. Proved U.S. reserves of natural gas have fallen to about half of the 1967 level as new reserve additions have failed to keep pace with natural gas production.



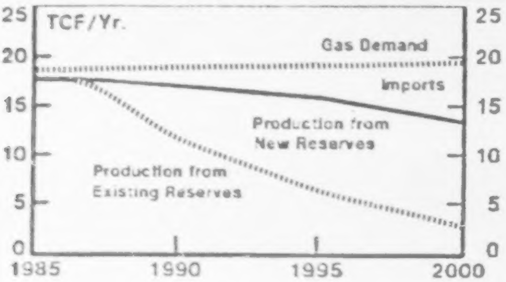
Proved Natural Gas Reserves (ex. Alaska)

The falloff in the U.S. rig count during the last few years will further aggravate the natural gas supply situation since there is a close correlation between the number of rigs operating and the amount of natural gas reserves discovered each year.

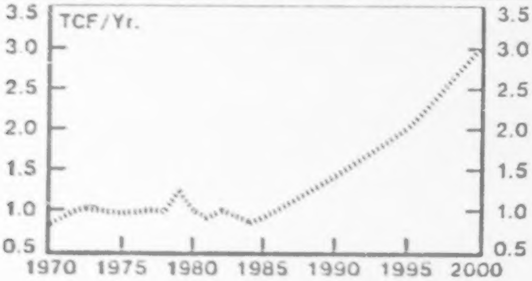


Total demand is expected to remain essentially flat at 18 TCF as shown below, while U.S. gas production is expected to decline from about 17 trillion cubic feet (TCF) in 1985 to about 15 TCF in 2000 excluding the negative supply effects of the FERC proposed rulemaking. As a result, U.S. gas imports under current regulations are projected to triple from 1 TCF in 1985 to 3 TCF in 2000. Most of the domestic gas production in the 1990s will have to come from new reserves as production from existing reserves rapidly falls off.

U.S. Natural Gas Supply/Demand
Proposed FERC Regulations



U.S. Natural Gas Imports



FERC'S PROPOSED NEW REGULATIONS

We strongly oppose FERC's proposed new regulations since the regulations would have a detrimental impact on U.S. natural gas production. Despite remarks by the FERC chairman to the contrary, the proposal ignores the detrimental impact it will have on supply. The proposed rulemaking sets the stage for a return of the gas industry back to the shortage and curtailment days of the 1970s, but now without even a viable means of handling curtailments.

The proposal focuses singularly on forcing down gas prices by encouraging pipelines to abrogate their contracts with producers and ignores the large reserve loss by forever keeping old gas prices at low levels (estimated by the Congressional Office of Technology Assessment to be 19 to 38 TCF of gas). FERC should raise the price of old gas to a more just and reasonable level if it is really interested in securing an adequate long-term supply of natural gas.

Gas is essential to the health and welfare of the nation's economy as well as the personal lives of the majority of the people in this country. We are certainly not opposed to trying out new ideas and ways of doing things. However, to adopt a proposal that the Commissioners themselves recognize would revolutionize the gas industry, but has many practical, legal, and even theoretical problems is wrong. It is essential for Congress to step in and see that reasoned judgment is brought to bear on a proposal that could so adversely affect the lives of so many.

FERC asserts that most of the proposal is "voluntary." We submit the "voluntary" aspect is effectively an illusion since those pipelines which refuse to become "transporters" will be at such a serious competitive disadvantage that this is nothing more than a subterfuge to do what FERC does not have the authority to do.

FERC ignores its duty of ensuring a reliable, adequate supply of gas by permitting the pipeline's service obligation to be dissipated. FERC unlawfully has derogated its responsibilities under the Natural Gas Act by allowing pipeline customers to decide whether, and to what extent, they can abrogate their contracts with their suppliers. That function is reserved, by law, to the Commission, not private parties. In addition, the Commission's proposal will severely compromise the pipeline's duties to perform its public utility responsibility to serve the public with adequate long-term supplies.

Mr. Chairman, we believe your Subcommittee should request the FERC Chairman to respond to the duty his agency has to see that those customers who depend solely on gas are properly looked after. We believe destroying long-term contracts between producers and pipelines, forgetting about large gas reserves that will be forever lost, dissipating the pipeline's service obligation, and simply saying the market will hopefully handle this half regulated, half free industry is an inadequate response to the duty his agency has been assigned.

FERC has a judicial mandate that if it is to continue some form of blanket transportation, it must be implemented on an open, non-discriminatory basis and must have the program in place by November 1, 1985 to avoid disruption of transportation arrangements. The task is relatively straightforward: To remove the regulatory impediments to anyone who wants to buy or sell gas and to give pipelines the incentives to supply the transportation needs of those buyers and sellers.

However, the Notice of Proposed Rulemaking (NOPR) contains a far more complex transportation proposal than is required and contains other proposals which are essentially extraneous to the achievement of open transportation: block billing, take-or-pay safe harbor and the unilateral right of firm pipeline customers to reduce demand. For reasons which are explained later, these non-transportation related features have significant legal and policy defects which cannot be cured and will prevent the early and necessary implementation of open transportation.

In short, the Commission must promulgate a straightforward, legally defensible transportation policy and must segregate the establishment of such a policy from other proposals which would jeopardize sustaining such a program on appeal, or which could significantly delay its implementation. An effective transportation policy can be implemented by a blanket, unconditional, non-discriminatory transportation program. Open transportation, coupled with the volumetric, downwardly flexible tariffs proposed by the Commission, will bring competition to the pipeline industry and will offer both buyers and sellers alternative marketing and purchasing opportunities.

Amoco's further comments will emphasize the principal policy and legal defects in the rule and then deal with the harmful effects which can be expected if it is not modified to simply encompass open transportation.

Legal Issues

Amoco believes that at least two aspects of the Commission's proposal are unlikely to withstand judicial scrutiny: Block billing and the "25 percent rule," describing the condition which allows a firm pipeline customer to reduce its contract demand 25 percent per year over a four-year period.

A. Block Billing

Block billing is legally indefensible for a number of reasons. First, it runs counter to the specific provisions of the Natural Gas Policy Act (NGPA). Section 601, which governs passthrough of pipeline purchase gas costs (and thus addresses the same transactions as block billing) does not provide that certain customers will bear the gas costs of certain NGPA categories. Surely, had something as revolutionary as block billing been contemplated by Congress, it would have been expressly stated in Section 601 or elsewhere. The fact that it was not is a powerful indication that such a scheme was never intended by Congress.

Where Congress intended differentiation in resale cost treatment, it spoke. Where it intended no distinction, it made none. In the NGPA, Title II incremental pricing is the only differentiation among customers which Congress established and there the Congress defined those who were to be treated differently. However, the NGPA Title II consumers bear no resemblance to the block billing distinctions set out in the NOPR. Indeed, the NOPR can be characterized as creating a new tier of incremental pricing not provided for in the NGPA.

Secondly, the Commission cannot depart from an historical practice which Congress assumed to be extant when it passed the NGPA. Congress recognized that rolled-in pricing is the traditional ratemaking method for pipeline resales. (See, for instance, Section 208 of the NGPA.) There is thus no doubt that the NGPA was enacted on the basis that rolled-in pricing was the "general principle" on which pipeline resale rates were established.

B. The 25 Percent Rule

To justify its action in providing the firm pipeline customer with discretionary, unilateral rights to, in effect, abrogate its service agreements with its suppliers, the Commission appears to invoke its power under Section 5(A) of the Natural Gas Act (NGA).

However, the Commission is placed under some very exacting standards by Section 5(A) to which it must adhere. There are essentially four:

1. The Commission can act only "after a hearing."
2. It must find the terms of the existing contract, rate schedule, or tariff to be "unjust, unreasonable, unduly discriminatory, or preferential."
3. The Commission "shall determine" the subsequent proper terms for the contract, rate schedule or tariff.
4. The Commission "shall fix" such terms by "order."

Each one of these prerequisites must be carried out before an action under Section 5(A) is effective. Note that it is the Commission's responsibility to perform the above-enumerated acts. The Commission must make certain determinations and cannot transfer or cede to private parties its responsibility for so doing.

However, the 25 percent rule does precisely this. In proposing it, the Commission has done nothing more than set certain outside limits (i.e., 25 percent per year for four years) on what is otherwise a customer's decision on whether and to what extent he shall abrogate his agreement with his pipeline suppliers. The Commission is leaving it up to the customer as to whether to alter his service agreement and, if so, to what degree. In short, the Commission is unlawfully ceding its authority under Section 5(A) to the pipeline's firm customers.

The fact that the Commission has set certain limits on the decision does not change the result. Even with these limits, the customer can still choose not to reduce his demand at all, or he can choose to reduce it by any percentage less than the prescribed limit. The customer, not the Commission, gets to "determine" what is the lawful extent of abrogation (or indeed, if it will abrogate at all), and can "fix" the extent of its obligations thereunder. Those functions are not the customer's under the NGA, they are the Commission's, and the Commission does not act in accordance with Section 5(A) if it does not make the findings called for under that section.

Finally, it is also probable that the 25 percent rule would be violating the Section 7(B) of the Natural Gas Act. The effect of the 25 percent rule is to give discretion to the pipeline customer regarding whether and to what extent the firm sales transaction is abandoned. Like the situation under Section 5(A), the Commission must determine whether abandonment is justified and not leave such decisions to private parties.

Policy Issues

Ironically, one of the most prominent features of the NOPR is the omission of an evaluation or analysis of how the program would affect long-term gas supply and how it would function in a time of shortage. The Commission must provide reasoned analysis of the effect of the NOPR on these areas of concern. Amoco is confident such an analysis will reveal serious shortcomings in the proposal. The following policy issues need to be addressed:

A. Open Transportation

Blanket transportation certificates assuring equal access opportunities, coupled with the volumetrically-based, downwardly flexible transportation rate proposed by the Commission should alleviate the non-competitive features of pipeline tariffs, particularly if the volumes are properly determined. This would give pipelines strong incentives to operate their business in an efficient manner.

B. 25 Percent Rule

The proposal goes too far in providing firm customers with the 25 percent per year firm demand reduction right. The 25 percent rule would undermine the ability of interstate pipelines to perform their traditional public utility function of providing a reliable and adequate supply of gas to the public. A pipeline must plan to achieve a balance in supply and demand so that it does not mislead its customers nor be rendered unable to perform its obligations to its customers.

The 25 percent rule would make it nearly impossible for a pipeline to perform this service function. Pipelines normally have to adjust supply to try to match expected demand. The 25 percent rule, by giving the pipeline's customers discretion to unilaterally reduce firm demand from their suppliers, would make the long-range supply planning of the pipeline effectively impossible.

C. Take-or-Pay Safe Harbor

The take-or-pay safe harbor proposal would frustrate negotiations. The so-called take-or-pay "problem" is not generic and thus cannot and should not be addressed by a set of uniform rules for all companies as set forth in the proposal. The renegotiation of contracts can involve many issues other than take-or-pay and thus cannot be neatly converted to a single formula.

The take-or-pay buyout proposal in the NOPR depends on the willingness of the parties to accede to its terms and can only work if it offers realistic terms on which to settle. However, the proposal is unworkable because it offers totally unrealistic terms to the producer. The proposal applies as yet undefined percentages to speculative amounts estimated by just one of the parties to the contract for only two years out of the entire life of the contract. For the resulting amount, the producer must effectively relinquish all rights to take-or-pay in the future. In our opinion, take-or-pay settlements will simply not be made on the basis of such an unrealistic approach.

D. Block Billing

The Commission should recognize that the only way to eliminate market distortions is to eliminate their cause, i.e., artificially low controlled prices on old gas. FERC has the clear authority to eliminate the market distortion problem. The Commission has ignored the explicit power given to it by Congress under Sections 104, 106(A), and 109 to increase "old" gas prices if circumstances demand. What is ironic is that in fashioning solutions to so-called market distortions, the Commission is resorting to measures of very dubious legality while ignoring a clear grant of power from Congress to achieve a thorough and workable solution via the raising of old gas prices.

Block billing's principal goal seems to be to place interstate pipelines on an equal footing for purposes of obtaining new or incremental gas supplies. However, in doing so, it simply shifts the present distortion from the pipeline level to the Local Distribution Company (LDC) and end user level. Unlike raising Section 104 prices, which would cause the cushion to disappear, block billing does not eliminate the effects of the cushion *as between* the pipeline's customers but rather aggravates the discriminatory effects of the cushion at the LDC and consumer level.

For example, one of the more serious consequences is the disparity which block billing sets up between LDCs and interstate pipelines. Under the NOPR, LDCs may go out and buy gas in the open market in competition with interstate pipelines, indeed, even with their own present or former pipeline supplier. Since the LDCs can roll in their Block 1 gas in structuring their bids for new gas, they hold the cards as against the pipelines who would not be able to factor in Block 1 gas. Thus, the combination of the 25 percent rule and block billing sets up a triple advantage for LDCs. They can keep their supplier's Block 1 gas, stop taking their supplier's Block 2 gas, and *then* have an advantage against that supplier in bidding for new Block 2 suppliers.

In a period of curtailment, this could have devastating effects on those remaining pipeline customers who, because of size or lack of resources, cannot, or do not, want to leave the pipeline system. The pipeline would be outbid, exacerbating the shortage for its remaining customers.

By requiring pipelines to reserve the lower priced old gas for their existing customers, instead of the current practice of allowing that gas to be rolled-in with more expensive new gas, FERC would be making the already contracted for higher cost new gas unmarketable. Further, the proposal to give the pipeline's customers the unilateral right to reduce their purchase obligations means that the pipelines would no longer have an assured market for the gas they contracted to purchase from producers.

This situation would, in turn, generate tremendous pressure on pipelines who lose these "core" market customers to abrogate established business practices including not honoring contractual obligations with their producer/suppliers. They may even attempt to erroneously use the above features to claim force majeure. These features of the proposal are the most objectionable and would do the gas industry the greatest harm. Who will look for new gas sources if contracts can be abrogated at any time? In addition, while encouraging abrogation of high-priced contracts, the proposal keeps in force old gas contracts at low prices that are grossly unfavorable to the producers. Finally, this action would result in the demise of long-term contracts in the producing industry, which are fundamental to a highly-capital intensive, long-lead time industry.

IMPACT OF NOPR ON GAS SUPPLY/DEMAND

Even under the current regulations, U.S. natural gas imports are expected to increase from 1 trillion cubic feet (TCF) in 1985 to about 3 TCF in 2000, as shown in the following table:

Under Current FERC Regulations

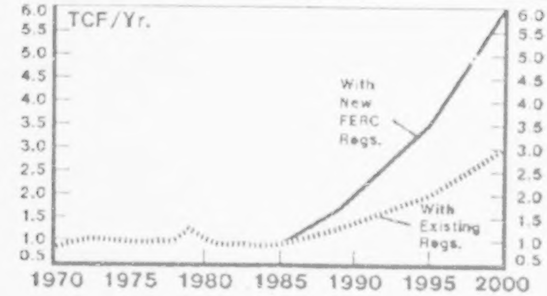
	TCF	
	1985	2000
U.S. Dry Gas Production	17	15
Imports	1	3
U.S. Gas Consumption	18	18

If the proposed new FERC regulations are implemented, domestic natural gas production is expected to be 2 TCF lower in the year 2000 than under the current regulations, and potential U.S. gas consumption is projected to be 1 TCF higher, requiring 6 TCF of imports as shown in the following table:

Under Proposed New FERC Regulations

	TCF	
	1985	2000
U.S. Dry Gas Production	17	13
Required Imports	1	6
U.S. Gas Consumption	18	19

U.S. Natural Gas Imports



It is not clear where 6 TCF of imports would come from. It is doubtful if Canada can supply more than 2 TCF. Perhaps Mexico and other sources could supply another 1 TCF. The remaining 3 TCF of natural gas demand would have to be satisfied by residual fuel oil and that would mean 1.5 million B/D of additional oil imports. Even without the proposed changes, U.S. oil imports are expected to increase from 5 million B/D in 1985 to 9 million B/D in the year 2000.

Oil's contribution to the U.S. trade deficit is projected to double in 1985 constant dollars from $50 billion in 1985 to $100 billion in 2000. The additional 1.5 million B/D of oil imports in 2000 on account of the new FERC regulations would increase U.S. vulnerability to unstable Middle East oil supplies even more and raise the trade deficit to $135 billion (in constant 1985 dollars) including the price impact. Including inflationary increases in crude oil prices would increase the total oil import bill to over $300 billion in 2000. The U.S. cannot afford this luxury just so that FERC can attempt to "level the field" for natural gas pipelines.

CONCLUSION

A new transportation program must be implemented by November 1, 1985. Amoco and others have identified numerous operational and legal problems with the non-transportation aspects of the NOPR which will require time to resolve and even then are likely to be challenged in the courts. The only way that FERC can realistically expect to have a viable transportation program in place by November 1 and not hopelessly bound up in litigation is to sever the transportation issues from the other aspects of the rulemaking. The Commission should focus its efforts on promulgating a competitive and non-discriminatory transportation system in a straightforward manner and seek to avoid the risks of judicial challenge.

Senator NICKLES. Dr. Eck, thank you very much.
Mr. Davis.

STATEMENT OF T.E. DAVIS, GENERAL MANAGER, NATURAL GAS DEPARTMENT, CONOCO, INC.

Mr. DAVIS. Mr. Chairman, Senators, I am Ted Davis, the general manager of the Natural Gas Department of Conoco. My department is responsible for the sale of Conoco's natural gas production, as well as the procurement of all gas supplies for DuPont, our parent company. I speak to you today as both a consumer and producer of natural gas. In 1984 Conoco produced 250 billion cubic feet of natural gas while DuPont and Conoco together consumed 150 billion cubic feet at 69 industrial facilities located in 26 States.

I will attempt to answer the important questions concerning the NOPR set forth in your invitation to speak before this subcommittee.

Conoco believes that the public interest will be better served by retaining the existing regulatory system, even though we feel there are better alternatives than by adopting the proposed FERC rulemaking in its present form.

Conoco strongly opposes the block billing proposal on the grounds that it is operationally unworkable, unduly discriminatory, and would have severe long-range economic and supply security consequences affecting all sectors of the economy. It would be unworkable because of conflicts with States' ratable take laws.

Block billing would not eliminate the distortions caused by the cushion of old gas. It would just repackage them. The cushion would shift from the interstate pipelines to the local distributors. Each State or local reglatory authority, not the FERC, would then determine how, or if, this short-term price windfall would be passed on to the end user.

Block billing would artificially create entitlements of low-cost gas to Block 1 users, primarily local distribution companies, based arbitrarily on their firm gas purchases from 1982 through 1984. The more efficient LDCs, those who aggressively pursued low-cost spot gas supplies for their customers during those years, would now be penalized relative to those who did nothing and continued to buy higher cost gas from their pipeline suppliers.

Interruptible customers, who also have major capital investments at risk, DuPont being one of them, and are the pipelines' swing customers throughout the year, would also be disadvantaged. Conoco contends this is unduly discriminatory and subject to legal challenge.

This new regulatory pricing structure would exert severe downward pressure on block 2, or new gas, prices. Contrary to what the FERC suggests, this would not by itself induce a more orderly market. Why? Each pipeline has a different percentage of old gas in its total system supply to pass on to its LDC customers.

Conversely, the volume and price of high-cost gas in a pipeline system's supply base would determine what its customers would have to pay for interruptible gas. Without the historical rolled-in pricing methodology, much of this gas could not compete with alternative energy sources at the burner tip when netted back to the wellhead.

If a commodity cannot be replaced for the price it is sold, there is little incentive to continue to spend scarce capital dollars in its pursuit. Producers cannot take the risk of one success in seven exploratory wells drilled without adequate cash-flow to back them up. The NOPR, as structured, will not give producers the cash-flows required to continue to explore for and develop U.S. gas reserves.

If the NOPR is implemented, block 2 annual revenue losses to producers would be in the $5 to $7 billion range. This would drastically reduce gas well drilling, leading to a significant decline of proved U.S. reserves and deliverability. When the current short-term deliverability surplus dissipates, speeded by minimal gas well drilling, imported energy would have to be used as a stop gap to fulfill domestic demand.

By the year 2000, the proved reserves we have on our books today will provide only 20 percent of the estimated demand, due to normal well declines. The remaining 80 percent will have to be supplied from new drilling discoveries and from imports. This is serious when you stop to think that the year 2000 is just 15 years away and that it takes 3 to 8 years to bring an onshore gas field from discovery to full production, and from 7 to 15 years for an offshore field to be brought to full production, and this is where most of the natural gas future discoveries are expected to be found. The United States does not have the luxury to allow a major hiatus in our natural gas exploration and development drilling.

Only Congress can provide this Nation with total decontrol of natural gas, and we applaud the efforts of those of you on the subcommittee who have labored long in this effort. However, you did empower the FERC, under the NGPA of 1978, with the authority to increase old gas ceiling prices to higher just and reasonable levels to bring them more in line with today's overall natural gas environment. If the FERC chose to do this, the Nation would be the clear winner.

The DOE recently estimated that 38 trillion cubic feet of old natural gas will not be recovered under today's low regulated price, much of this gas below 50 cents per MCF. When the cash-flows from a well can no longer pay the well's operating expenses, it is plugged and abandoned. If a higher but reasonable price could be obtained, the operator of this well could perform maintenance work or well stimulation, which would extend the useful life of the well and allow economic recovery of the reserves.

This old gas pool is the Nation's least expensive major supply of natural gas. The wells are already drilled, the reserves are there, the pipelines are connected. It would be a travesty to allow more than 2 full years of natural gas demand for the United States to be prematurely abandoned, never to be recovered.

In summary, no one wants to return to the shortages and curtailments of the 1970's. The only way to provide U.S. consumers with reliable long-term secure supply at the lowest reasonable cost is to allow prices of natural gas which will justify the risks and expenditures incurred in developing reserves. Then all gas reserves, old and new, would be developed in a rational and orderly manner justified by true market economics. To continue with a natural gas market half-free and half-slave will not serve this Nation's best interest.

Thank you.

Senator NICKLES. Mr. Davis, thank you very much.

Senator Ford, we're pleased that you are here. Do you have any opening comments? Do you want to finish the panel?

Senator FORD. Go ahead and finish the panel. I understand the Senator from New Mexico entered my statement and that's all I have. I know you have got a lot of folks; I don't want to delay you.

Thank you.

Senator NICKLES. Thank you, Senator Ford. I appreciate it.

Mr. Hogan.

STATEMENT OF THOMAS E. HOGAN, PRESIDENT, WHELESS DRILLING CO. ON BEHALF OF THE INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS

Mr. HOGAN. Mr. Chairman and Senators, thank you very much. My name is Thomas E. Hogan, president of Wheless Drilling Co. in Shreveport, LA. I appear today as the 1985 president of the International Association of Drilling Contractors, IADC, a trade association composed of over 1,500 member companies engaged in all aspects of oil and gas drilling, exploration and production. Wheless Drilling Co. is engaged in onshore drilling activities primarily in Louisiana, Arkansas, and Texas.

A large majority of IADC's members are onshore drilling contractors. As such, they have provided the hardware to find and develop our Nation's oil and gas energy resources. As most of you know, the oil and gas industry is enduring significant hard times. This is best illustrated by the precipitous decline in the rotary rig count, which now stands at slightly over 1,900. This roughly equates with the rig count in 1976.

In 1981, the rig count averaged 3,973. Thus, there has been a reduction of almost 50 percent in the number of rigs working throughout the United States. This represents a steady, dangerous decline from 1981, which was a very good year for the drilling business. In 1982, that number fell to 3,116, in 1983 to 2,226, in 1984 it's slightly rebounded to 2,428, and currently is bobbing around the 2,000 number.

An equally unsettling trend has occurred in the total number of available rigs. From a high of 4,803 in 1981 we find ourselves with only 4,120 rigs available today and dropping fast. With the number of available rigs shrinking comes an even-greater risk that when an upturn in demand for drilling services begins there may well be a shortage of those rigs, with a consequent pinch in the development of new oil and gas reserves.

The loss of rigs over these 5 years has been due to various factors tied to the financial health of the contract drilling industry. Many companies have gone bankrupt and many rigs are simply rusting in stacks or are being cannibalized as cash-short contractors borrow pieces of existing rigs when they formerly bought new parts.

Another indicator of the weakness of our industry is the total number of IADC's membership. Just 3 years ago our membership stood at over 2,000 member companies, and we are today 25 percent off that mark. And IADC represents virtually the entire contract drilling industry.

The rulemaking proposed by FERC, in particular part D, will by most conservative estimates reduce drilling by 30 percent. Oil companies, already in a cash flow bind, have drastically reduced their exploration budgets, and FERC now proposes through NOPR 85-1 to skew the natural gas markets further by enabling certain favored utilities and large industrial consumers to raid low-cost gas supplies. This attempt to adjust overnight the results of decades of bad Federal regulation will have a serious adverse impact on the contract drilling business, as higher cost deregulated gas is shut in for lack of a market.

NGPA invited the development of high cost gas reserves, and the contract drilling industry rose to the challenge with the construction of very large and very expensive deep-drilling rigs. The pipelines' problem with high cost take-or-pay contracts and the sudden drop in oil prices has already made deep gas drilling uneconomic. The FERC proposed rulemaking would deliver the rabbit punch to producers struggling to manage their new gas reserves which the Federal Government induced them to seek.

FERC proposes to accomplish what Congress has not permitted. Since Congress has not yet taken the step to deregulate old natural gas, the market is even now trying to sort itself out. This would be greatly aided, of course, if natural gas could seek market levels just as oil and coal do. IADC remains strongly in favor of total deregulation of all natural gas categories.

Through this proposed rulemaking, FERC attempts to tilt the natural gas market at all costs in favor of the local distribution companies, which are impatient with the facts of the marketplace. The much talked about level playing field sought by FERC is an attempt to give the LDC's free run of that field while forcing producers and pipelines to the benches, and the drilling contractors to the showers.

The contract drilling industry simply cannot survive a 30 percent or more drop in drilling activity. The FERC rulemaking, if adopted, would accelerate the number of bankruptcies in our industry, the declining available rig rate, and the growing dependence on foreign sources of oil and gas. The Congress and FERC, and its predecessor, the FPC, have through years of keeping natural gas at artificially low-price levels created the unlevel playing field we find ourselves on.

The industry is gradually working the market out, but this will not be done without a sharing of the pain necessary to untangle years of misguided legislative and regulatory policies for natural gas. The contract drilling industry has taken quite a bit of the pain up to now; producers who cannot market new gas under NGPA are suffering as well. FERC's attempt to insulate the LDC's from pain is an end run effort on the playing field. The congressional referee should blow the whistle on FERC and declare this proposed rulemaking out of bounds.

Thank you, Mr. Chairman.

Senator NICKLES. Thank you very much, Mr. Hogan. We appreciate it.

Mr. Broun.

STATEMENT OF E.C. BROUN, JR., EXECUTIVE VICE PRESIDENT, HUGHES TOOL CO., ON BEHALF OF THE PETROLEUM EQUIPMENT SUPPLIERS ASSOCIATION

Mr. **Broun**. Thank you, Mr. Chairman.

My name is E.C. Broun. I am executive vice president of the Hughes Tool Co. and appear today as the elected president of the Petroleum Equipment Suppliers Association.

PESA thanks this committee for giving us the opportunity to tell our story. Established in 1933, PESA is a national association of 287 oil field equipment manufacturers, service and supply companies located in 44 States. I might comment that this includes all the States represented by members of this subcommittee. We do not produce a cubic foot of natural gas or a barrel of oil, but our livelihood depends on serving those companies and independents that do.

Last year our industry sales were $33 billion. Excluding Schlumberger, a French company based in the Netherlands Antilles, earnings of the industry were a negative $100 million. In the process, the industry furnished jobs for roughly 300,000 people. It's interesting to note that this number exceeded 600,000 people in 1982.

Others on the panel have documented the effect of the regulations on the industry's ability to locate and have ready for market the needed natural gas supplies for future generations. I would like to address these pressures as to the effects on the manufacturing/service/supply industry as necessary elements of the exploration for natural gas reserves.

This industry is historically cyclical. There are two characteristics of drilling activity. First of all, it is price sensitive. Second, exploration and development for natural gas reserves calls upon the manufacturing, service and supply industry to perform at its highest level technologically. The upswings in activity are directly related to the increase in product pricing. When the prospect of discovering hydrocarbon reserves and delivering them to market at a significant economic return, the marketplace reacts by making funds available.

The degree of research and technology which natural gas exploration and production entails is demonstrated by the industry pattern of expenditures by just one segment, the manufacturers of petroleum equipment. In the period 1972 to 1982, this segment of our industry invested more than $3.6 billion in new plant and equipment. Responding to the oil embargo and the natural gas crisis of the 1970's, the increased demands of our customers caused our industry to sustain a compound annual growth rate of 32.4 percent in those 10 years.

The manufacturers of petroleum equipment invested in the future in the belief that the demand for hydrocarbon energy would justify this planning. Employment increased more than threefold. Total employment for the manufacturing and service segments of the industry was over 600,000 in March 1982, an increase of 400 percent in those 10 years.

At this point, a number of developments began to change the outlook for the industry. The first hints came in the cutback on the efforts to develop synthetic substitutes. Oil industry planners were sending a signal; the marketplace will not support the high cost of substitutes when plenty of oil and gas was available.

Efforts at conservation, coupled with the economic slowdown outside the United States reduced the demand for oil and gas. These developments contributed to the feeling that the U.S. domestic hydrocarbon reserves were not as important as they seemed to be. The Nation mistakenly believes that the world oil glut exists in this country. Add to these pressures the economic impact which hits vendors when many of their customers are involved in restructuring their operations to meet the challenges currently facing them.

The impact of the FERC proposed regulations is another element of uncertainty. It will put additional pressure on our customers because of the element of uncertainty it injects into the marketplace. The industry we serve is rapidly deteriorating. The cause of this is the uncertainty which the industry faces. The uncertainty is due to an absence of clear and consistent energy policy.

The lack of clear rules puts into jeopardy the future investments which are the lifeblood of this industry. The result which is most apparent is the loss of that precious elements of our economy—jobs. As I have stated before, we declined from 600,000 to less than 300,000 currently. I have for the record, Mr. Chairman, the SIC code decline in jobs by year for the two SIC codes 3533 and 1381 for manufacturing and service.

Another, and maybe more serious, effect of these inconsistent policies is the reduction in the ability of the U.S. oil and gas companies to find and develop reserves of oil and gas. Every barrel of reserves discovered domestically saves dollars which would otherwise be a part of our balance of trade deficit. We feel strongly that any change needs to be carefully thought out.

This country lacks an energy policy. One of the direct results of this is going to be the serious impairment of the manufacturing/service/supply industry. Supplying the needs of the oil and gas industry is a highly complex business which requires a great deal of custom work by skilled employees. As the figures I have already given you show, we have lost a great number of these people.

In addition, in response to the current price pressures on gas and oil, many of our member companies have been merging or closing their doors. In short, America's need for gas will increase, but well-intentioned but misguided proposals which foster uncertainty cast doubt on whether industry will be able to respond to the demands of our customers.

The FERC's NOPR block billing proposal, as Mr. Davis and Mr. Tell said, would drive $5 to $6 billion in cash flow from our drilling budgets, and this is a blow that we in the service industry can't stand. Many of our member companies are faced with shutting down or taking bankruptcy, and this could well be the straw that broke the camel's back.

Mr. Chairman, PES \ believes that it's time that serious consideration be given to creating an environment in which it is possible to plan, such as total deregulation of natural gas. Abrupt changes cause economic losses which we as an industry find difficult to sustain in today's environment. We believe that we have a key role which, if rightly viewed, pertains to the national security of our Nation.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Broun follows:]

STATEMENT

OF

E. C. BROUN, JR.

HUGHES TOOL COMPANY

HOUSTON, TEXAS

On Behalf of the

PETROLEUM EQUIPMENT SUPPLIERS ASSOCIATION

Before the

SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

of the

COMMITTEE ON ENERGY AND NATURAL RESOURCES

U.S. SENATE

September 19, 1985

Good morning, Mr. Chairman. My name is E. C. Broun. I am Executive Vice President of Hughes Tool Company in Houston, Texas. I also serve as the elected President of the Petroleum Equipment Suppliers Association (PESA).

Established in 1933, PESA is a national association of 287 oilfield equipment manufacturers, supply and service companies.

Last year, industry sales were $33 billion with earnings of less than $1 billion. Excluding Schlumberger, a French company based in the Netherlands Antilles, the earnings of the industry were a negative $100 million. Roughly one third of the industry's sales, approximately $10 billion, is generated overseas. In the process, the industry furnishes employment for 250,000 people. This number exceeded 600,000 in 1982.

Others on this panel will document the effect of the regulations on the industry's ability to locate and have ready for market the needed natural gas supplies for future generations. I would like to address these pressures as to the effects on the manufacturing/ service/ supply industry as necessary elements of the exploration for natural gas reserves.

This industry is historically cyclical. There are two characteristics of drilling activity. First of all, it is price sensitive. Secondly, exploration and development for natural gas reserves calls upon the manufacturing/service/supply industry to

PERFORM AT ITS HIGHEST LEVELS TECHNOLOGICALLY.

THE UP-SWINGS IN ACTIVITY ARE DIRECTLY RELATED TO THE INCREASE IN PRODUCT PRICING. WHEN THE PROSPECT OF DISCOVERING HYDROCARBON RESERVES AND DELIVERING THEM TO MARKET OFFERS SIGNIFICANT ECONOMIC RETURN, THE MARKETPLACE REACTS BY MAKING FUNDS AVAILABLE.

THE DEGREE OF RESEARCH AND TECHNOLOGY WHICH NATURAL GAS EXPLORATION AND PRODUCTION ENTAILS IS DEMONSTRATED BY THE INDUSTRY PATTERNS OF EXPENDITURES BY JUST ONE SEGMENT--THE MANUFACTURERS OF PETROLEUM EQUIPMENT. IN THE PERIOD 1972-1982, THIS SEGMENT OF OUR INDUSTRY INVESTED MORE THAN $3.6 BILLION IN NEW PLANTS AND EQUIPMENT. RESPONDING TO THE OIL EMBARGO AND THE INCREASED DEMANDS OF OUR CUSTOMERS, THE INDUSTRY SUSTAINED A COMPOUND ANNUAL GROWTH RATE OF 32.4 PERCENT IN THOSE TEN YEARS. IT IS INTERESTING TO NOTE THAT THIS RATE EXCEEDED THE 25 PERCENT COMPOUND GROWTH IN SALES FOR THE SAME PERIOD. THE MANUFACTURERS OF PETROLEUM EQUIPMENT INVESTED IN THE FUTURE IN THE BELIEF THAT THE DEMAND FOR HYDROCARBON ENERGY WOULD JUSTIFY THIS PLANNING. EMPLOYMENT INCREASED MORE THAN THREE-FOLD. TOTAL EMPLOYMENT FOR THE MANUFACTURING AND SERVICE SEGMENTS OF THE INDUSTRY WAS OVER 600,000 IN MARCH OF 1982--AN INCREASE OF 400 PERCENT IN TEN YEARS.

AT THIS POINT, A NUMBER OF DEVELOPMENTS BEGAN TO CHANGE THE OUTLOOK FOR THE INDUSTRY. THE FIRST HINTS CAME IN THE CUTBACK ON THE EFFORTS TO DEVELOP SYNTHETIC SUBSTITUTES. OIL INDUSTRY PLANNERS

WERE SENDING A SIGNAL, THE MARKETPLACE WILL NOT SUPPORT THE HIGH COST OF SUBSTITUTES WHEN PLENTY OF OIL AND GAS WAS AVAILABLE.

EFFORTS AT CONSERVATION COUPLED WITH THE ECONOMIC SLOWDOWN OUTSIDE OF THE UNITED STATES REDUCED THE DEMAND FOR OIL AND GAS. THESE DEVELOPMENTS CONTRIBUTED TO THE FEELING THAT U.S. DOMESTIC HYDROCARBON RESERVES WERE NOT AS IMPORTANT AS THEY SEEMED TO BE.

ADD TO THESE PRESSURES THE ECONOMIC IMPACT WHICH HITS VENDORS WHEN MANY OF THEIR CUSTOMERS ARE INVOLVED IN RESTRUCTURING THEIR OPERATIONS TO MEET THE CHALLENGES CURRENTLY FACING THEM.

THE IMPACT OF THE PROPOSED FERC REGULATIONS IS ANOTHER ELEMENT OF UNCERTAINTY. WE EXPECT THAT IT WILL PUT ADDITIONAL PRESSURE ON OUR CUSTOMERS BECAUSE OF THE ELEMENT OF UNCERTAINTY IT INJECTS INTO THE MARKETPLACE.

THE INDUSTRY WE SERVE IS RAPIDLY DETERIORATING. THE CAUSE OF THIS IS THE UNCERTAINTY WHICH THE INDUSTRY FACES. THE UNCERTAINTY IS DUE TO AN ABSENCE OF CLEAR AND CONSISTANT ENERGY POLICY. THE LACK OF CLEAR RULES PUTS INTO JEOPARDY THE FUTURE INVESTMENTS WHICH ARE THE LIFE BLOOD OF THIS INDUSTRY. THE RESULT WHICH IS MOST APPARENT IS THE LOSS OF THAT PRESCIOUS ELEMENT OF OUR ECONOMY - JOBS. AS I STATED BEFORE, WE DECLINED FROM 600,000 TO LESS THAN 250,000.

ANOTHER, AND MAYBE MORE SERIOUS EFFECT OF THESE INCONSISTENT POLICIES IS THE REDUCTION IN THE ABILITY OF THE U.S. OIL AND GAS

COMPANIES TO FIND AND DEVELOP RESERVES OF OIL AND GAS. EVERY BARREL OF RESERVES DISCOVERED SAVE DOLLARS WHICH WOULD OTHERWISE BE A PART OF OUR BALANCE.

WE FEEL STRONGLY THAT ANY CHANGE NEEDS TO BE CAREFULLY THOUGHT OUT. THIS COUNTRY LACKS AN ENERGY POLICY. ONE OF THE DIRECT RESULTS OF THIS IS GOING TO BE THE SERIOUS IMPAIRMENT OF THE MANUFACTURING/SERVICE/SUPPLY INDUSTRY. SUPPLYING THE NEEDS OF THE OIL AND GAS INDUSTRY IS A HIGHLY COMPLEX BUSINESS WHICH REQUIRES A GREAT DEAL OF CUSTOM WORK BY SKILLED EMPLOYEES. AS THE FIGURES I HAVE ALREADY GIVEN YOU SHOW, WE HAVE LOST A GREAT NUMBER OF THESE PEOPLE. IN ADDITION, IN RESPONSE TO THE CURRENT PRICE PRESSURES ON GAS AND OIL, MANY OF OUR MEMBER COMPANIES HAVE BEEN MERGING OR CLOSING THEIR DOORS. IN SHORT, AMERICA'S NEED FOR GAS WILL INCREASE, BUT WELL-INTENTIONED BUT MISGUIDED PROPOSALS WHICH FOSTER UNCERTAINTY CAST DOUBT ON WHETHER OUR INDUSTRY WILL BE ABLE TO RESPOND TO THE DEMANDS OF OUR CUSTOMERS.

MR. CHAIRMAN, PESA BELIEVES THAT IT IS TIME THAT SERIOUS CONSIDERATION BE GIVEN TO CREATING AN ENVIRONMENT IN WHICH IT IS POSSIBLE TO PLAN. ABRUPT CHANGE CAUSES ECONOMIC LOSSES WHICH WE AS AN INDUSTRY FIND DIFICULT TO SUSTAIN IN TODAY'S ENVIRONMENT. WE BELIEVE THAT WE HAVE A KEY ROLE, WHICH IF RIGHTLY VIEWED, PERTAINS TO THE NATIONAL SECURITY OF OUR NATION. ALL WE ASK IS THAT WE BE GIVEN AN OPPORTUNITY TO PLAY ON A LEVEL FIELD, AND THAT THE REFEREES BE RESTRICTED FROM MOVING THE GOAL POSTS WHILE PLAY IS IN PROGRESS.

MR. CHAIRMAN, I THANK YOU FOR THE OPPORTUNITY TO PARTICIPATE IN THESE HEARINGS. I WILL BE PLEASED TO ANSWER ANY QUESTIONS THAT YOU MAY HAVE.

Senator Nickles. Thank you, Mr. Broun.

If the committee doesn't object, Senator Domenici you mentioned that you had a time obligation. If there is no objection, you can go ahead and ask your questions.

Senator Domenici. Thank you very much, Mr. Chairman. I have a statement I'd like you to put in the record, please.

Senator Nickles. Certainly.

[The prepared statement of Senator Domenici follows:]

Statement of Hon. Pete V. Domenici, a U.S. Senator From the State of New Mexico

Mr. Chairman, thank you for holding these hearings. While the FERC set out to promulgate a rule to help with the transition from full regulation to partial regulation as mandated by the NGPA I think they have managed to "one-up us" when it comes to affecting change in the natural gas market.

I think the FERC has achieved some workable provisions in their proposed rule, like the transportation provision, I have grave reservations about some parts.

We have to approach this proposed rule on a very fundamental level and ask "What is the FERC trying to achieve?" and "Have they succeeded?"

The FERC is trying to set up a gas system whereby producers "see" market prices. So they have created a category in which they have placed high priced gas. Will the producers "see" the effects of the market? Not unless the commission prevents those who really regulate the far ends of these pipeline systems from doing what they do. That is, Conservation Commission who regulate production in gas fields so as to avoid waste and Public Utility Commissions which regulate burner-tip prices. I hope the FERC does not intend to preempt these bodies but, if they do not—how will they achieve their goal of making all producers respond to a uniform market picture.

Certainly the FERC is trying to cope with their perception of "dual markets." They perceive a very high priced category of gas and a category of all other gas. We in the Congress had a different dual market facing us in 1978. It was the interstate versus intrastate market. We tried to deal with that and had some success. We may have created another dual market with old and new gas. But will the FERC achieve its goal through Block pricing? Obviously not. This proposed rule does not apply to intrastates and furthermore, Block pricing is just that categories of gas which are receiving different treatment.

One thing a few of us set out to do in the NGPA which many believed would not work was provide incentives for production. We wanted to keep stripper wells producing and encourage exploration. I think we succeeded (or should I say, the producers did). If the FERC intends to change all that with this proposed rule, then this may be the one goal they achieve. How can we expect to encourage exploration if the benchmark price for gas becomes the old artificially cheap gas of Block I? Rolled-in pricing provides a mechanism whereby new and marginally more expensive gas can enter the market. This new incremental pricing scheme of the FERC will do just what we have seen incremental pricing do in the past—discourage new customers from entering the markets and encourage customers with at other alternatives to leave it. The result is the remaining customers share the fixed costs left behind. I thought we had a consensus that this was not the right direction.

Thank you, Mr. Chairman, I hope the FERC will think twice before finalizing its Block pricing scheme.

Senator Domenici. It's very difficult for me to choose which one of these witnesses to ask questions, but, Mr. Chairman, I wish for my questions that we had an official representative of FERC here. But I understand we have had them before and perhaps you would intend to ask them again, if there's a need.

Senator Nickles. Certainly.

Senator Domenici. Let me just try. I would hope one of you will just give me the answer rather quickly.

What percent of the gas being consumed on an annual basis is block 1 gas under these orders? Do you have a rough percent?

Mr. Davis. Forty percent.

Senator DOMENICI. That means 40 percent is in block 1 and 60 percent is in block 2, and then there is sort of an unknown commodity out there that's the spot, which is gas that's just available but competes with those today; is that right? Forty and 60 equals 100, so where's the spot?

Dr. ECK. That would be in block 2, sir, actually.

Senator DOMENICI. Block 2, but kind of defined as spot, as we understand it in the market.

Now what's happened to natural gas pricing in the last 2 years as it affects the consumer? Has the price of gas been going up, down, or what's happened?

Mr. RUSSELL. I think the consumers' price in most cases has stayed constant or has gone up. The producer's realization has gone down.

Senator DOMENICI. Has there been substantial renegotiation in the industry at large in terms of what is now in block 2? I mean, the purpose of this order, if it has any merit, is to try to get the block 2 gas to come down in overall price. I understand there's been a substantial renegotiation occurring regularly in that part of the market; is that correct?

Mr. RUSSELL. Absolutely.

Senator DOMENICI. Is that definable? Ten percent? Five percent?

Mr. CONKLIN. It would be difficult to define it right now, Senator, I would think. I can't define it for myself.

Senator DOMENICI. Is it fair to say that until recently, perhaps even until the contemplation of this order, that it has been an ongoing situation between the purchaser and/or pipeline and the contract—and those who produced and have the right to sell at the wellhead?

Mr. RUSSELL. Very definitely. I think in most cases what you see is the tradeoff of lower price on the part of the producer in exchange for the opportunity to move some gas.

Senator DOMENICI. Would it be fair to assume that that has shown a dramatic change since the contemplation of this order in the marketplace? Or has it changed the attitude? Not yet?

Dr. ECK. I think it has been a continual process, sir, right along.

Senator DOMENICI. Wouldn't you assume that that will get more difficult as the reality of this order, if it is to be, focuses in or if you were in court 2 years on whether it's valid of not?

Dr. ECK. Yes, sir. That's the exact problem. If we end up in court for 2 or 3 years, there won't be any negotiation and everybody will be waiting to see what the law is.

Senator DOMENICI. That would be rather mutual. Both sides would feel like they wouldn't want to negotiate there; is that correct? You all and the producer would be in a state of confusion.

Mr. TELL. Senator, I think also that the order may provide a basis, at least it will be alleged that there has been a force majeure.

Senator DOMENICI. I'm going to get to that.

Now tell me, because I really don't understand, who is going to have the right to buy block 1 gas. I mean obviously 40 percent isn't going to supply demand and it's very, very cheap, and 60 percent is in block 2 and it's a mixture, very high-priced gas that we encouraged, some medium-price gas, some other, but 40 won't solve the demand at the end over there.

So how under this new order—who's going to get the 40 percent benefit and how do we decide where the 60 percent goes?

Dr. ECK. Sir, there is no specificity here. The concept is the older existing or existing customers will get this, but really it would be up to the individual State public utility commissions, and there's no assurance whatsoever that homeowners or any specified group will necessarily get the benefits, if any, of this proposal.

Senator DOMENICI. But those who sell it in the pipelines will not have the opportunity to mix the two. They will be delivering this 40 percent low-price gas. That's why you call it a block; is that correct?

Mr. CONKLIN. That's correct.

Senator DOMENICI. Somewhere else down the line the mix is going to occur because clearly there's not enough to go around; is that right?

Mr. RUSSELL. That's correct.

Senator DOMENICI. Now as I understand it, then, the block 2 gas which is not going to be rolled in, some of which is very, very high, what you're telling us is that there may be no way in any assured manner to sell that; is that correct?

Mr. RUSSELL. Absolutely.

Senator DOMENICI. So what's going to happen if you can't sell it? You can't pay for it, is that right? You won't buy it. Now is that where the idea that you're just going to cancel these contracts—may—and talk about force majeure, that along came some act of God and said you're out from under them; is that right?

Mr. TELL. Exactly, yes.

Senator DOMENICI. Does everyone sort of agree with that? All of the independent producers out there in the United States understand that.

Mr. CONKLIN. I think we understand it very well. If we don't, our bankers understand it very well.

Senator DOMENICI. Now we argued up here for 2 years about a law which would have caused the abrogation of contracts. Is it fair to assume that there will be a significant abrogation of contracts at least attempted here by those who are charged with purchasing this block 2 gas under non-market-out contract provisions?

Mr. RUSSELL. No doubt about it.

Mr. TELL. Absolutely.

Senator DOMENICI. Of course, you're not agreeing with that because you are representing those that don't want it to happen, but those who are in the contracts, I assume you are all saying you are going to; is that right?

Dr. ECK. Well, we anticipate this would happen because again the block 2 will have difficulty competing with the block 1 in many, many markets and there will be these pressures leading to contract nonfulfillment.

Mr. DAVIS. What it is, your pipeline companies will be competing to keep the markets they have, their core markets, and when they have to sell the block 2 gas by itself some of it will be so high they cannot compete with alternative fuels such as fuel oil when netted back to the wellhead. When you add a dollar or so transportation on, you can't afford to drill the well.

So it really cuts back on what the block 2 pricing could be and the pipelines retaining their markets.

Senator DOMENICI. And block 2 is everything other than low-priced gas.

Mr. DAVIS. That's correct, sir.

Senator DOMENICI. So just give us a range, for the record. That would be as low as and as high as what, all mixed in that block 2—not mixed but available under the contracts?

Mr. CONKLIN. $4.36 would be a high, and a low would be $3—$2-something. Then your block 1 would be 78 cents and $2.

Senator DOMENICI. Seventy-eight. So——

Mr. CONKLIN. Seventy-eight cents.

Senator DOMENICI. And a portion of block 2 is under firm contracts with no market clearance mechanism and some rather substantial take-or-pay provisions; is that correct? How much of it are those kind of agreements that are really not negotiable and you have to pay that price and you have to take-or-pay? Do we know a percent?

Mr. RUSSELL. I think I can make a guess based on Shell's business. Overall we sell about 10 percent of our gas on the spot market and all the spot gas is in block 2, what would be in block 2. So, you know, come down from that.

Senator DOMENICI. All right. Any other rough ways to give us an estimate?

Mr. DAVIS. We sell approximately 10 percent of Conoco's gas in the spot market.

Senator DOMENICI. Is it fair then to say that this is an attempt to continue regulated block 1 and to force a deregulation of block 2 rather quickly?

Mr. TELL. I wouldn't say to force a deregulation. It is deregulated.

Senator DOMENICI. Use another word. Force a what?

Mr. TELL. Well, it's to artificially drive down the contract price to a level less than what it otherwise would be under deregulation.

Senator DOMENICI. And to some extent, a major extent, to say we don't care what the contracts say?

Mr. TELL. Exactly.

Senator DOMENICI. I have no further questions, Mr. Chairman.

Senator NICKLES. Senator Domenici, thank you very much.

We heard from all of our panelists—correct me if I'm wrong—that all of you recognize and realize because of the court orders that we need some type of a market provision to be able to move gas. Is that correct?

Do all of you support the NOPR as it deals with the contract carriage or the movement of, marketing of gas? Is there anybody that disagrees with that particular provision of it, or at least the principle of it?

Mr. CONKLIN. I think we agree with the principle, Senator. You know, there is always—there are still some things we'd like to see done, of course, but with the principle of the transportation, yes.

Senator NICKLES. You realize that the special marketing orders, because of the court decision, needed to be replaced and so FERC was given the responsibility by the court to come up with a mechanism to move the gas, and you agree with that. Is that unanimous with the panel?

Mr. HOUSE. I think, Senator, it's important to note from the independents' viewpoint that those regulations need to be expanded significantly to allow people that are probably not quite as sophisticated as some of the majors at this table access to that transportation.

Senator NICKLES. All right.

The other thing that I heard that was unanimous from the table was disagreement both in principle and also in implementation of block billing. Is that correct? And I heard, I was picking up phrases from "it won't work" or "unworkable" or "unfair" or "contested in courts" or "inequities" or "moving or transfering the advantage", I guess, that you'd have on low-priced gas instead of the rolling in.

You've been rolling in gas prices for—well, I guess you would have to go back to the *Phillips* decision. We will have the pipelines testify in a minute, but there is unanimous opposition to that from this panel.

Do all of you favor the FERC spinning off or canceling the block billing and really doing what the court was directing them to do, and that was come up with just a transportation method and not get into the billing, pricing mechanism?

Mr. RUSSELL. Yes.

Mr. TELL. Mr. Chairman, I'd have to say if that's the alternative to the course they're on, without question. I don't believe that rolled-in pricing is legally mandated. I think there are other options and indeed I think the interests of the industry long-term would be better served if all gas were sold as a commodity and not this distortion that the rolled-in cushion creates.

And our suggestion is that if they're going to interfere and artificially drive down deregulated contracts at a minimum they ought to make under their existing authority an adjustment in the lawful ceiling prices. It's not deregulation. It's not contract abrogation. But it would produce a result that's essentially revenue neutral for the wellhead, and that that is what FERC ought to seriously consider.

Senator NICKLES. I understand what you're saying, Mr. Tell, but I don't totally agree with it. My personal belief would be that they should move something on the transportation mechanism and allow Congress to be setting up the billing mechanism, because we wrestled as Senator Domenici said, for a couple of years with pricing, and there's major questions dealing with the pricing. And I think one of the falacies that FERC came out with was the assumption that we were going to forever leave that 40-percent category of old gas alone.

Is there an agreement on the table? I think Mr. Russell mentioned that you believe that there would be something like 37 trillion cubic feet of gas left in the ground if we followed that?

Mr. RUSSELL. If we do not deregulate old gas, if we do not permit old gas to come to market-clearing levels, then we will waste somewhere in the range of 31 to 37 trillion cubic feet of gas. It will be left in the ground. It will be forever abandoned.

Senator NICKLES. How much gas is that?

Mr. RUSSELL. That is 2 years' supply for the United States.

Senator NICKLES. One other question. I think I heard some differing comments on abrogation or on the 25 percent, or at least I didn't hear from every—I heard those first two comments, I think, from everybody on the panel. I did hear a lot of concern, I guess, and maybe some objections to the 25 percent market-out.

Is there a consensus that that would be objectionable or not?

Mr. RUSSELL. It would be very objectionable.

Senator NICKLES. Objectionable all the way across the board.

One final question. Many people speculate that FERC is going to go forward with this and announce their final ruling very similar along the proposed rule. If that's the case, what would you like to see Congress do?

Mr. RUSSELL. I would like to see Congress accelerate consideration of deregulation of all gas immediately.

Senator NICKLES. Accelerate deregulation of all gas?

I've got a bill to deregulate gas. There's probably some other proposals that are floating through Congress. But you would still be looking at a very chaotic——

Dr. Eck, you mentioned that you expect that prolonged court battle if they proceeded with the ruling. I'm zeroing in on billing right now. Do you see that being tied up in court for some time?

Dr. ECK. There's no question that the pipelines, the distributors or, more particularly, the producers are going to take this right straight into the courthouse because of the tremendous problem. First of all, not only the old contracts but signing new contracts, we really won't know where we're going to be until we get this resolved.

But as far as what the Congress should do, I think it's imperative that Congress convey to FERC that they have the authority to go ahead with transportation and this is a good thing to do, but they just don't have the authority to get involved in this block billing and this pricing business. That's been the purview of the Congress and if something needs to be done here Congress is going to do it.

Mr. TELL. Mr. Chairman, I'd just like to emphasize again a point I made, that the rationale, the justification for this block pricing, there isn't any economic or any policy explanation. If you look in the NOPR, all it says is that Congress apparently intended it, and they are making Congress the villain of the piece, and I think the responsibility to justify it should be squarely with FERC.

There's nothing in the legislative history of the NGPA that can support that, and I would certainly hope there would be some way that it could be clear to FERC that if they're going to set this out and take the consequences of the results which have been described in some detail this morning that it's their responsibility and it's not something they can cop out on by saying Congress intended it.

Clearly NGPA gave FERC plenty of legal latitude to produce a much more equitable result, and if you look at the legislative history of NGPA the congressional intent was to offer the marginal price to the producer on a deregulated basis and not produce, I think, the world's all-time record renege, which they are now attempting to associate the Congress with, indeed as having mandated it, and tied their hands and compelled that result.

I think that's unfair and I think that at a minimum they should be required to independently justify the action they are taking.

Senator NICKLES. Under current statutes do any of you believe that the FERC has the legal authority to do the block billing proposal?

Mr. TELL. In its present form, absolutely not.

Senator NICKLES. A couple of final questions. Mr. Broun, you are associated with the Hughes Tool Co., which monitors the activity in the oil and gas industry. How many plants do you have running now? You mentioned the loss of 30,000 jobs in the last year. How many plants does Hughes Tool Co. have running today and how many did you have running a few years ago?

Mr. BROUN. Well, it's a net negative number. We have shut down nine plants. We have sold five of them, including three in California. We have terminated 9,000 jobs in our company, from a high of 23,000.

I would like to respond to your question of what we in the service industry would like Congress to do.

Senator NICKLES. OK.

Mr. BROUN. We would like you to create a free market in natural gas and deregulate natural gas. I've heard speculation that this confusion could last 3 to 4 years. If it does, there well may not be any service companies left to get the wells drilled.

Senator NICKLES. One final question. Mr. House, the impact is somewhat different between majors and independents. Independents, particularly a lot of them, have a higher percentage of their reserves and assets tied up in block 2, as compared to the majors in block 1. So more or less a greater share, or do you agree that possibly a greater share of the brunt of the block billing would have a more negative impact on some of these smaller independents, say, as compared to the majors?

Mr. HOUSE. Senator, as you are well aware, the independents today are facing incredible pressures from all side—decreasing capital available to us, significant tax implications appear to be coming our way, not to mention just a flat market for our product. We think that the NOPR potentially, and particularly the block pricing provisions of it, will be the end for many independents that have struggled to hang on so far.

I very much agree that the independents, compared to our percentage of production, will bear a much greater burden than the majors will in this particular rulemaking.

Senator NICKLES. I appreciate your coming.

Senator Bingaman.

Senator BINGAMAN. Thank you very much. I just will ask one question since there are really many other witnesses.

Mr. Hogan, I think you made reference to estimates that the results of section D being implemented would be a reduction in drilling of at least 30 percent. Is that an accurate statement of what you said?

Mr. HOGAN. Yes.

Senator BINGAMAN. I just wondered if any of the other witnesses would want to agree or disassociate themselves from that. Are these estimates of reduction in drilling activity something that we could actually put some confidence in, or is this pure speculation? I'd be interested in anybody who's looked into it.

Mr. RUSSELL. Well, Senator, there's an excellent correlation between industry cash-flow and the number of rigs that run, so you can get right squarely into it. As a matter of fact, I believe in Mr. Conklin's testimony there is a curve, is there not, Danny, that shows that?

Mr. CONKLIN. Yes. We anticipate that of course the less cash-flow, as he just stated, but would correlate with the decrease in wells drilled.

Senator BINGAMAN. So the 30-percent reduction figure is reasonably agreed upon, or is that optimistic, pessimistic, or about right?

Mr. TELL. Senator, I think that's reasonable. It could be conservative. As I indicated, our studies, which we will be filing with FERC, show that this proposal will remove in the neighborhood of $5 billion a year of cash-flow, and that's just about half of the money that the total industry spent in 1984 for exploration and drilling, including dry holes.

So 30 percent doesn't sound unreasonable to me, and it doesn't even take into consideration the psychological impact on the industry from the renege, where the ground rules changed after we had made massive investments in the late 1970's and early 1980's in response to the supply shortages under NGPA, which represented that we would have a free market for this gas.

Mr. HOGAN. Senator, on that figure, if I may comment on it again, that we felt was a conservative figure. That was based on the majors and the larger independents. We think the impact will have far greater significance on the independents and an overall figure could be greater than 30 percent.

Senator BINGAMAN. Dr. Eck?

Dr. ECK. I'd like to comment that's an average number. What I'm fearful of is the impact on frontier areas and on deep wells and basically wells that are costly, because with the uncertainty, with the inability to sign contracts, the inability to foresee any kind of predictable pricing, it's those high cost and high risk wells that are going to go out.

So the States that are not fortunate enough to have all the shallow reservoirs are the ones that are going to be hurt the most by this kind of initiative.

Senator BINGAMAN. Thank you very much.

Senator NICKLES. Thank you, Senator.

Senator Evans.

Senator EVANS. Thank you, Mr. Chairman.

I must say that the longer I listen the more confused I get, I guess. Let me ask some questions to try to get at that.

You say that the block 1, the amount of block 1 gas now available is about 40 percent, as I understood it, and block 2, the rest, is 60 percent. How long is that supply—that block 1 gas is presumably old gas. You know it's a confined amount. How long will that last? It's currently 40 percent. What are your predictions over a period of time? That eventually will phase out, won't it?

Mr. RUSSELL. At current prices, you know, you're looking at a gradual plugging out of wells and therefore a gradual disappearance of this over time, probably in the neighborhood of 15 to 20 years for it to substantially disappear.

Senator EVANS. So over 15 to 20 years the old gas will disappear, and this block 1, block 2 pricing will not be a real factor any more unless we devise something else.

Mr. RUSSELL. It will disappear, along with about 31 to 37 trillion cubic feet of gas that shouldn't disappear.

Senator EVANS. Well, you say the gas disappears. How will the gas disappear?

Mr. RUSSELL. Well, when we plug out a field the economics are not such that one can go back and redevelop the field. You're looking at marginal economics.

Senator EVANS. Presumably at some price—the gas is still there at some price?

Mr. RUSSELL. The gas is still there, and the point is that if that gas were allowed to go at whatever the market-clearing level is, then the economics would favor continuing production operations so that one could recover the additional gas. At lower prices, you reach the point that economically you can no longer continue to produce a field.

Senator EVANS. I understand all that, but it seems to me it's a little—it's not quite accurate. I was going to say deceptive, but I don't think that's quite the right word. It's inaccurate to say that the gas disappears. The gas is still there; it's just not economic——

Mr. RUSSELL. Physically you are exactly right. Physically the gas does not disappear. It happens to be inaccessible economically.

Senator EVANS. At current prices or at something like current prices.

Mr. RUSSELL. Right.

Senator EVANS. At some price, it's still available.

Mr. TELL. Well, indeed it might be available at current market prices, but not at the artificially low prices under regulation of block 1. I think that's the point.

Senator EVANS. OK. I heard much in the testimony about giving appropriate pricing. As we develop new demand and new users come on line, wouldn't the appropriate price signal for those new users be the current cost of acquiring the commodity?

Mr. RUSSELL. Yes, sure.

Senator EVANS. If that's true, then, isn't it an inaccurate price signal to have a rolled-in price of old and new gas which doesn't give to this expanding group of customers the appropriate pricing signal as to what new gas costs?

Mr. CONKLIN. Well, it would depend on where the customer would be located. He could be located where he could take advantage of block 1, but then the next customer may not, and dependent upon where he would be the pipeline that had the low-cost gas would be selling to him.

Senator EVANS. I understand there are many quirks and I'm not asking these questions having made up my mind whether FERC is on the right track or the wrong track or whether block 1 or block 2 pricing is appropriate or not. But the broader question of trying to give appropriate price signals on energy to potential customers and it seems to me that if you keep that old gas and roll it in with the new gas prices and sell it all at a fairly narrow block that you are not giving appropriate price signals and the customer is not getting the kind of accurate price signals vis-a-vis other competing fuels.

It seems to me that your testimony bears that out by suggesting that if you do separate them out and that if you do have a block 2 set of prices that you're going to lose a lot of money. Well, the only way you're going to lose a lot of money is if you can't sell the gas, and the only way you can't sell the gas is because something else is cheaper.

Mr. RUSSELL. That's right.

Senator EVANS. And it seems to me if that's true then aren't you really saying that an alternative energy source is cheaper for the customer than natural gas, as it costs to get natural gas out of the ground today?

Mr. TELL. That might be true for certain categories of gas as were set by the distortions of the cushion and the multitiered pricing system, but you're sawing off the peaks but you are not filling in the valleys. If you smoothed it out into level terrain, gas could compete quite satisfactorily in many markets. But if you just take a snapshot at a particular price level, you can't generalize from that. You should look at the aggregate revenues and the average unit revenues, and they are quite competitive, half the price of oil.

Senator EVANS. I understand all of that. But what I'm trying to get at is the sort of fundamental economics. Dr. Eck, you're up.

Dr. ECK. I think the issues you are addressing are important issues, but they have been largely resolved in the marketplace. Two or three years ago it was true that the rolled-in price of gas was way below the new gas price. A couple of things have happened in the last 2 or 3 years.

The average price of gas has come up and the price of new gas has come down to the point where the newly discovered gas that's being offered for sale is at essentially the average price and sometimes even cheaper than the average price.

Senator EVANS. If that's true, then what's the problem?

Dr. ECK. The problem is this new initiative would set up these artificial blocks and force a further and potentially sharp additional reduction in pricing so the consumer would see these phony prices as a function of blocks and be encouraged to use even more gas, shut in more coal, use more gas. The producer gets the wrong signal because he is getting these artificial prices, so he drills even fewer wells and we end up with a big shortage, just like we did the last time that regulations artificially forced the price of gas to too low a level.

Senator EVANS. I think you're right as far as those who have access to that precious old gas, which would be that 40 percent which would slowly shrink over a period of time and those customers presumably would be pushed into higher and higher prices as the supply of old gas would shrink.

Is that essentially what would happen under this FERC proposal?

Dr. ECK. Well, essentially what FERC says is that they believe indeed the prices will be forced down as a consequence of their block system. I think most everybody that's looked at the mechanics of this says that the net effect of these two blocks is going to be to sharply reduce the price of gas, particularly the price of new gas. And that's what we're all worried about.

Senator **Evans**. But you're saying the new gas is already being sold at or less than market price.

Dr. **Eck**. It is already cheap and it's going to be forced down to additionally low levels that will further shut in the drilling business

Senator **Evans**. Why would that be necessary? If it's already being sold at a market price and there is no lessening of demand, there might even be an increase in demand, I suppose, as you suggest from some of those who have the benefit of cheap gas so that there would be an overall expansion, but no expansion in the amount of old gas.

So presumably that leads to an expansion in the amount of new gas used. I don't see where you're talking about a huge decrease in revenue. If there's an increased demand for new gas, it seems to me under basic economics that that should drive the price up, not down.

Dr. **Eck**. Well, basically what we have is a condition in the marketplace today of supplies that are currently not being consumed. There is some excess supply, and what happens is all the gas in effect becomes for sale at a given point in time. It's rather like having every house on the block for sale on the same day, you know, and that inevitably will force prices down in the immediate timeframe.

Senator **Evans**. On the overall or—there are so many different circumstances, I suppose, throughout the country, depending on who has the availability of old gas and how much and what the price or the actual price of new gas to that consumer might be, and the price of alternative fuels.

But on the overall would you agree that if the 40 percent of customers who have access to old gas suddenly get a big benefit, which is presumably what they would get—is that true?

Dr. **Eck**. Well, that's not clear. That's what we don't know. Again, it's sort of up to the public utility commissions at the State level to determine who does what here.

Senator **Evans**. Well, they have to separate it out. Somebody gets the benefit.

Dr. **Eck**. Well, the price of gas has been falling in the field now for some time, as we indicated, yet residential gas prices on average have been probably going up, not down. It looks as if if anybody's getting any benefit, it's the industrial user and not the residential user, from this kind of activity.

Senator **Evans**. But whether it's residential or industrial, somebody would get the benefit of considerably lower gas prices if they had the full benefit of that old gas price; is that correct?

Dr. **Eck**. Of course it's always possible that pipeline margins or distribution margins go up, too. I mean, that could be one of the somebodies.

Mr. **Tell**. Benefit is a siren song if it only lasts for a year or two and then it leads to a price spike because it's artificially forced new gas price below replacement cost levels and therefore the new gas is not physically available in the future in the quantities required to cover the market demand. Then the price goes up.

It seems to me that it's much more in the interests of consumers, particularly in a period when you have had decline in prices with some slight supply overhangs in the short term, to see this thing done in a smooth way, the way the market would do it if you had all gas selling as a commodity and not these cyclical spikes that regulation has produced for the last 13 years.

Senator EVANS. I recognize the problems of regulation and what it tends to do in getting us away from the market, but if you're suggesting just selling gas as an overall commodity, a single fungible commodity, at an average price, then it seems to me you want to mute the idea that you are really giving accurate economic price signals to the customers.

Mr. TELL. That's the way crude oil is sold. That's the way refined products are sold. That's the way coal is sold, and that's the way commodities are sold in the market. Consumers seem to understand the price signals that the market produces for other commodities. I don't know why gas would be so different.

Senator EVANS. So you would be opposed to any kind of a marginal price system.

Mr. TELL. Well, what we find is that the marginal price is held out as a regulatory theory to squeeze prices down in the short term and to induce producers to bet on the come. But when you get there, the ground rules change again.

Senator EVANS. I'm not suggesting the ground rules be changed, but what I am suggesting is the question of whether you do or don't think marginal pricing is an appropriate mechanism to give accurate price signals as to what—and I'm not talking even about just natural gas alone, but whether that's an appropriate thing for all commodities.

Mr. TELL. The experience of the gas industry with marginal pricing under the NGPA has created such economic dislocations because consumers get false signals from the rolled-in pricing concept that some pipeline systems and distribution systems, I think, with the test of hindsight have made very uneconomic investments and that's the problem now that FERC is addressing, is it's trying to get some market discipline and some competition into this industry and which we as producers want because our commodity must be competitive in the end market.

Senator EVANS. So you think they're trying to do the right thing but doing it in the wrong way? Or do you think they're trying to do the wrong thing in the right way?

Mr. TELL. I would accept that generalization. I'm not sure all members of the panel would.

Senator EVANS. Dr. Eck.

Dr. ECK. I think there's no question moving to a free market's difficult, and we have seen that in other industries—the airline business and trucks and so on. But we have made a lot of progress, and I would submit the market's doing pretty well right now, that the signals in the marketplace as far as new gas are concerned seem to be working to a reasonable degree.

And what FERC's going to do is really take away the free market system that has been developed under the NGPA and go to a system that effectively is regulating and forcing down artificially the free market price, and that's what we're all concerned about, you know, that the sort of phony block system is not going to result in marginal pricing but effect a pseudo-regulated price that will not be market clearing and is going to result in a shortage. That's the problem.

Senator EVANS. Would you say that currently, gas, when you have that privilege of rolling everything together and selling it at the average, that gas is being priced now on the basis of the overall average in terms of cost of production plus a reasonable profit, or is it being priced to compete directly with residual oil or whatever other alternative fuels are available?

Dr. ECK. Well, there's no question that the current market situation is one of intensely competitive conditions and residual fuel had been a factor, but now the price of gas is below residual fuel in virtually all markets, so that, you know, there's not that sort of a problem. But again I would submit the present system is a whole lot better from the point of view of the producers.

We understand how the market is working in this unregulated market. We are extremely fearful of any effort to go back to regulations, the regulations that impact on the price of new gas.

Senator EVANS. Let me follow that one step further, then. If you're below alternative fuels in most markets, that suggests that the real competition then is within the natural gas industry rather than between the gas industry and other alternative fuels. Is that the current case?

Thank you, Mr. Chairman.

Senator NICKLES. Thank you, Senator Evans.

Senator Ford, do you have any comments?

Senator FORD. Very quick. We've taken enough time and I'll submit my basic questions to the panel and ask them to answer in writing if they will.

Mr. Russell, real quickly, when you deregulate old it becomes new gas as it relates to the price. Am I correct in that?

Mr. RUSSELL. I'm sorry?

Senator FORD. When you deregulate old gas, it becomes then new gas as it relates to price or whatever the market value is?

Mr. RUSSELL. It goes wherever the market clears.

Senator FORD. But you increase the price or can increase the price based on the market?

Mr. RUSSELL. The price in some instances will increase, that's correct.

Senator FORD. All right. So I tried to deregulate old gas effective in 1992. I made that motion and it failed. If we were able to deregulate old gas by 1992, would we lose that 30 trillion cubic feet?

Mr. RUSSELL. You would lose some of it, Senator. Now I'll be happy to furnish you for the record what that amount would be.

Senator FORD. If you would do that.

Mr. RUSSELL. But every year that you delay you do lose some fields and wells by abandonment.

Senator FORD. Well, when we deregulated oil under so many barrels per well, we saw them go back and uncap them, and I suspect that might be done on natural gas.

Dr. Eck, you may answer this question. The cost of generating electricity in the United States—and I'll read from the Energy Daily dated yesterday—coal was the cheapest, nuclear was next, and oil was way out there. Where is natural gas? They didn't even include natural gas as it relates to the factor for generating electricity.

Dr. Eck. Well, sir, I believe it depends on whether we're talking about big plants or small plants.

Senator Ford. Take an average. We're talking averages here. You know, you can argue your case. I hope you will just give me an answer. I want to quit, you know. I just want an answer.

Dr. Eck. The right answer is coal is cheaper than gas for large plants. In many instances in small plants delivered gas is cheaper than coal due to other factors.

Senator Ford. You're talking about delivered gas is just like delivered coal?

Dr. Eck. Yes, sir.

Senator Ford. So in some instances gas may be cheaper. What's the overall average?

Dr. Eck. Coal is cheaper.

Senator Ford. Thank you, sir.

Senator Nickles. Thank you, Senator Ford.

Senator Bumpers.

Senator Bumpers. Mr. Chairman, just two or three quick questions.

Obviously the gas industry is in economic trouble right now and there is pressure building to repeal the Fuel Use Act, which limits the use of natural gas by big industrial users. What, if any, effect would the repeal of the Fuel Use Act have on the gas industry right now? Would it push prices up? Would it cause them to stay about the same? Would it affect the contract carriage problem?

Dr. Eck, would you respond?

Dr. Eck. We generally favor anything that makes the market freer and provides a bigger market, so we do favor amendments, as suggested. I really don't think it would have a great deal of impact, quite honestly, and the reason for that is as we indicated in the case of natural gas used in electric power generation most new electric power generation capacity, newly contracted, is already going to the gas business, and again that's because these are very small generation plants and the gas is going there.

So I haven't really thought of the Fuel Use Act as having a great deal of impact on the market for fuel in the new electric power generation business.

Now as far as industry is concerned, no question there might be some improved market opportunities and we favor it. But the big, big market out there I think is prospective. This is electric power generation and the current legislation seems to allow gas to compete fairly effectively in that market.

Senator Bumpers. What were the natural gas reserves in this country at the end of 1984?

Dr. Eck. It's roughly 10 years of supply.

Senator Bumpers. How many trillion cubic feet?

Mr. Conklin. 196, 197.

Senator Bumpers. And how did that compare with the end of 1983?

Dr. Eck. It's been going steadily down each year for roughly the last 10 years. I think last year the reserves dropped was it around four TCF or something like that?

Mr. Conklin. We decreased 3 trillion last year.

Senator Bumpers. There has been a fairly constant decrease over the last several years, between 3 to 4 trillion cubic feet per year.

Mr. Conklin. In 1981 we were about even and there was another year I've forgotten, 1978, I think.

Mr. Davis. One important thing to remember in that 197 is that 34 of it is in Alaska that we can't get to.

Senator Bumpers. How much longer can you depend on the Alaskan reserves? Are you talking about Prudhoe Bay?

Mr. Davis. Yes, sir.

Senator Bumpers. How much longer can we depend on Prudhoe Bay gas?

Mr. Davis. We can't get any down here.

Mr. Conklin. There's 168 in the lower 48.

Senator Bumpers. If we built the Alaskan pipeline, what would be its capacity, approximately 2 trillion cubic feet a year?

Dr. Eck. I think it was in the area of one TCF per year. Incidentally, that line will never be built if we don't have any contracts.

Senator Bumpers. Does this proposal mean that some of the contracts between producers and pipeline companies will be abrogated?

Mr. Conklin. I think that would be a decent assumption.

Mr. Russell. Yes.

Senator Bumpers. In some cases the pipeline companies have made sizable investments based upon these contracts. If this regulation goes into effect and these companies lose the ability to keep that pipeline fully utilized or at least utilized to the extent they anticipated when they made the investment, they will continue to have fixed costs associated with these investments, such as amortization of the pipeline, et cetera.

Has any provision been made to protect the residential consumers from feeling the effects associated with the pipelines' loss of revenue due to meeting these fixed costs?

Mr. Russell. To my knowledge, none in this NOPR.

Senator Bumpers. Do you think this situation should be addressed or not? No one knows precisely where the impact of these proposed regulations will be felt most strongly. It would depend on how the market situation fleshes out after the regulations go into effect.

I generally favor contract carriage and intend to vote for it if I possibly can. However, I'm a bit concerned about who will ultimately going to pick up the fixed costs some pipeline companies might have difficulty meeting if they lose a lot of their business.

Mr. Tell. I would think that would become an increasingly serious problem if the block billing is permitted to stay in place because future supplies available to the pipeline clearly are going to be declining and, as you say, the fixed costs are there and the unit costs are going up.

Senator Bumpers. Is that an absolute or an assumption that their supplies will dwindle under block billing?

Mr. CONKLIN. If we make an assumption that the price for the gas coming on stream would be decreasing and our capital is decreasing then, for instance, my investors would not be really excited about helping in the supply end of the industry. So with that assumption, they would be decreasing.

Mr. TELL. Senator, I think before you arrived it was noted for the record that the estimates are that the block billing will reduce wellhead revenues in the magnitude of $5 billion per year and that's essentially half of the total expenditures made in 1984 by the producing industry in exploring and developing for new gas reserves.

So clearly this is going to have a devastating effect on the level of exploration activity, which is already declining, and in time there will certainly be much less gas available at the wellhead and yet those fixed costs on the pipeline system are there to be covered.

Mr. HOGAN. And, Senator, I have a very, very difficult time separating the money the pipelines invested in the pipelines with money that the exploration companies invested in exploration.

Senator BUMPERS. So you say it's just as fair for one as it is for others?

Mr. HOGAN. I agree, yes.

Senator BUMPERS. Well, I wouldn't argue with that, certainly. I'm not trying to protect the pipelines. I am thinking about the cost the consumer may be asked to pick up. I'm talking about a potential increase to the consumer. The rates have been set based on the price of that pipeline gas. If the pipeline company has to raise the price for their limited number of end users in order to accommodate the effects of these regulations, then obviously not just the residential consumers but presumably everyone on that distribution system will be faced with a rate increase.

Mr. RUSSELL. Senator, I think part of the answer to that is that maybe the pipeline companies are going to have to run a little tidier operation.

Senator BUMPERS. I don't have any quarrel with that either.

Dr. Eck, did you want to comment on that?

Dr. ECK. I think what you have done, Senator, is hit a logical inconsistency in the NOPR and that is, first of all, you need gas to put in the pipeline if we're going to have contract carriage, and in effect we have an NOPR that is going to make contract carriage available, in effect mandatory, but it's going to reduce the amount of gas available to put in those lines.

And so inevitably we're going to get into the situation that you are addressing, that somebody's going to pay the bill here, and I'm kind of afraid it's going to be the guy at the end of the pipeline that going to suffer the short end.

Senator BUMPERS. He always pays, doesn't he?

Dr. ECK. He's the one that's going to get the short end and the higher cost.

Senator BUMPERS. What do you think would happen if we went to a two-tier pricing system rather than 27 pricing mechanisms, as the Wall Street Journal suggested in an editorial this morning?

Mr. TELL. I'm just not familiar with the specifics of that proposal enough to respond, Senator.

Senator **Bumpers**. The Natural Gas Supply Association estimates that under the FERC plan old gas customers would pay 78 cents an MCF compared with $4.36 an MCF for high price users, a difference of $3.58. That contrasts with the difference now of $1.67 on rolled-in gas. Moreover, NGSA says that this block billing scheme would cost producers $3 billion to $5 billion which would otherwise go for new drilling.

Is that the point you've been trying to make?

Mr. **Conklin**. That's the point we've been making, Senator.

Senator **Bumpers**. Some States have statutes that require purchasers to take equal amounts of gas from all wells available without regard to the price of the gas from any given well. If a purchaser has to take equal quantities of gas from both high and low cost wells, how can the purchaser design a purchasing strategy that reward producers for reducing price by increasing the takes from the producer?

Dr. **Eck**. Well, this is a basic inconsistency, sir, with the whole approach, that the State conservation laws that provide for ratable take are just per se inconsistent with the basic concept of the NOPR.

Sir; I would like to respond just generically to your previous question on a two-price system. Two-price systems just don't work, and that's basically what the NOPR would really have. Block 1/block 2, that is a two-price. They don't work in any market. They don't work in any market. There is always the problem of arbitrage between these prices and you just can't have two prices, whether it's in foreign exchange or beans or corn or oil or gas.

You just can't have two price markets. That just doesn't make any sense at all.

Senator **Bumpers**. Is anybody able to get the maximum price for gas under the pricing system that we have at present?

Mr. **Conklin**. For new contracts? I haven't.

Senator **Bumpers**. Deep gas is decontrolled, is it not?

Mr. **Conklin**. Yes, sir.

Senator **Bumpers**. What is the highest priced category of controlled gas right now? What is the highest price you could charge under any controlled price for that category of gas?

Senator **Nickles**. Senator, I will just tell you that we just counted up. There are 17 different price categories under the 104 and 106. Everything else was deregulated January 1, 1985.

Senator **Bumpers**. What is the highest price?

Senator **Nickles**. $2.51 for post-1974 gas under 104.

Senator **Bumpers**. What was the price again?

Senator **Nickles**. $2.51. I hear some mumbling. I don't know.

Mr. **Russell**. Tight sand gas at about $5.

Senator **Bumpers**. Nobody's getting $5 for gas, are they, except maybe under a long-term contract?

Dr. **Eck**. Yes, sir; that's the point. Nobody's selling any new gas at $5, but there are some deliveries under the terms of the old contracts.

Senator **Bumpers**. What is the market for gas right now? What's the most you can get for it?

Mr. **Russell**. Spot gas is going for, in some instances, as low as $1.90.

Senator BUMPERS. $1.90?

Mr. RUSSELL. That's right.

Mr. CONKLIN. Our market in the Texas panhandle is about $2.25 to $2.40 today.

Senator BUMPERS. Can you sign a long-term contract for that?

Mr. CONKLIN. Yes, sir; I can. I'm not too happy to, but yes; I can.

Senator BUMPERS. Are you signing long-term contracts for that amount?

Mr. CONKLIN. Yes, sir; although we have clauses that protect us.

Senator BUMPERS. Clauses that give you a rabbit hole?

Mr. CONKLIN. But they've got the same rabbit hole.

Senator BUMPERS. Let's get back to my question about those States that do require taking of equal amounts from all wells available. If there were a producer who chose to sell less than equal amounts and thereby reduce the price, he is prohibited from doing so under the statutes right now, isn't he?

Mr. CONKLIN. In Texas we have that problem. The Railroad Commission helps us along with that problem in Texas.

Dr. ECK. Yes, sir. You are essentially correct. There are absolute problems with the compatibility of State conservation laws which are ratable take and the potential for differential lifting.

Senator BUMPERS. Where is such a law in effect?

Senator NICKLES. Oklahoma and Texas both have ratable takes, and New Mexico as well, I believe. And to help the Senator in his question, I possibly might ask the panel does the panel see a real problem with NOPR in overriding the State ratable take laws?

Dr. ECK. No question there's a problem there. No question that's a legal problem. That's one of the reasons we're going to be in the courthouse.

Senator NICKLES. I am sure that is true also. To further answer the Senator's question, I apologize, I was looking strictly at the 104 table. There are 17, I think, different categories for 104, and $2.51 is the highest pricing category under 104. There is also another seven price categories, so we're now down from 28 to 23 post-January 1, 1985, and there are the tight sands gas, very little gas in that category. There is $6 for certain tight sands and stripper gas, $4.35 and others, but the majority of gas that we're looking at is in that old controlled price category, the lower figures.

Senator BUMPERS. If we were to deregulate gas tomorrow, who would drill in the tight sands and 15,000 to 30,000-foot wells? Is anybody doing it now?

Mr. CONKLIN. I don't think the marketplace is saying that that gas should come on stream. If we were in a totally free market, eventually the marketplace would tell us when it was time for it to come on stream. Today it is not—obviously would not be time.

Mr. HOGAN. Senator, there are still places where it's economic to drill for tight sand gas, and obviously some people think on the deep drilling that it's economic under certain circumstances because there is some still going on. It's strictly a function of the amount of reserves you can build up and the dollars you expect to get for them.

Senator BUMPERS. The risks associated with exploration are reduced to some extent in today's market, aren't they? The potential for finding gas is pretty good right now.

Mr. HOGAN. Well, there's not a deep wildcatting going on.

Senator BUMPERS. That's really my question.

Mr. HOGAN. Right.

Dr. ECK. Sir; I think a good answer to that question, though, is that we may not be able to contract for immediate delivery, but there may well be a potential, if we continue to have contracts, that we could contract for lifting this gas 5 years from now so that we would be willing to go in and make the preliminary investments today under those rules, if they are going to prevail.

Mr. TELL. And I think there's another important point, Senator, and that is if you were to permit the older gas to move up to today's market-clearing level, you would find substantial reserves in those older fields that it would now become economic to develop and produce. There would be a definite supply response with deregulation today. It may not be the deep, tight sand gas, but we've had estimates of from 31 to 37 trillion cubic feet of new supplies in the older fields that it's presently uneconomic to produce at these artificially low regulated prices.

Senator BUMPERS. Gentlemen, I thank you. Thank you, Mr. Chairman.

Senator NICKLES. Thank you, Senator Bumpers. I appreciate your interest and I particularly appreciate your comments on ratable takes. To our panelists, I appreciate your cooperation. I think we have had some good statements before the committee and I may submit additional questions or other committee members may as well.

Thank you very much.

Would the second panel please come forward? We're going to need to run.

Persons having conversations, we would appreciate it if you would take them outside.

To our second and third panels, as you can tell we had a very interesting discussion with several Senators, which usually happens when we have several Senators. We end up getting a little behind on time, so I would appreciate it if everyone would stay within the 5 minutes, if possible, and I appreciate your attendance.

Mr. King.

STATEMENT OF PETER J. KING, JR., VICE CHAIRMAN, COLORADO INTERSTATE GAS CO., AND CHAIRMAN, INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

Mr. KING. Mr. Chairman, I am Peter J. King, Jr., vice president of Colorado Interstate Gas Co. and chairman of INGAA, the Interstate Natural Gas Association of America. I appreciate this opportunity to appear before the subcommittee.

Without doubt, the NOPR is the most significant regulatory proposal the Commission has ever made in relation to interstate natural gas pipelines. INGAA shares the Commission's goal of assuring consumers the lowest reasonable rates consistent with reliable long-term service. But in our opinion significant changes in the NOPR will be necessary to meet this goal.

In our comments filed with the Commission, INGAA identified flaws we see in the proposed rulemaking and offer suggestions for improving the proposal. These comments and my statement here today reflect the views of a majority of INGAA's members.

Mr. Chairman, in our view the Commission has not demonstrated the need to replace rolled-in pricing with block billing. The Commission's proposal to require that old gas be reserved for existing customers and to place all new gas, regardless of price, into a single block could cripple the pipelines' ability to compete for gas sales in its traditional markets, much less new markets.

The proposed take-or-pay relief will not work. Producers will have little incentive to negotiate, and even if they should pipelines will find it impossible to finance the large buyout payments that would be necessary to conform to the NOPR. Unless the Commission develops a workable approach to take-or-pay, we seriously question whether the integrated NOPR package will work.

Voluntary carriage has become an important aspect of the interstate natural gas pipeline business, and thus streamlined transportation regulations are needed. But the transportation program proposed in the rulemaking does not recognize the service obligations and long-term supply commitments upon which the pipeline systems have been designed.

An example is the proposed right of historical sales customers to abandon sales service. The proposal also suffers from a number of practical flaws which I describe in greater detail in my written statement.

Turning, Mr. Chairman, to the first question posed by the subcommittee, I believe that the existing regulatory system would serve the public interest better than the NOPR has proposed. The existing voluntary carriage regulations were working and moving in the right direction. The blanket certificate program, which provided an expedited means of transporting gas for others, was very beneficial.

In addition, the innovative SMP program had been of considerable assistance to a number of companies. However, the recent court of appeals decisions vacating these programs will preclude a return to the existing regulatory system. Working alternatives to these programs are needed and are available. In our written comments we suggest modifications to the NOPR to provide such alternatives.

With regard to the second question regarding the workability and legality of the NOPR, unless the NOPR is substantially modified it is unworkable and the Commission's goals will not be met. We also believe that because of the breadth and complexity of the NOPR litigation is inevitable. In addition, the current uncertainty confronting the industry as a result of the NOPR and the prospects of extended litigation makes planning extremely difficult.

Regarding the NOPR's ability to accomplish the Commission's stated goal, it is unlikely that any regulatory system, especially the NOPR, can assure the availability and reliability of long-term supplies of natural gas. To the extent the NOPR causes pipelines to strive to make block 2 gas more marketable, natural gas prices at the wellhead will be lower in the short term.

However, the NOPR did result in lower pipeline sales and higher take-or-pay exposure that would ultimately mean increased cost to the consumer. By eliminating rolled-in pricing, the NOPR clouds the long-term outlook for exploration and development of new supplies of natural gas.

This brings me, Mr. Chairman, to your fourth and final question regarding exploration for new gas supplies and production from existing reserves. As I just mentioned, I am quite concerned about the potential negative impact that the NOPR will have on future exploration and development. The producers here today have addressed that question in detail.

With respect to production of existing reserves, the NOPR's mandatory block billing procedure will affect production levels in three ways, depending upon interaction with State laws. First, there will be incentives for pipelines to maximize production of block 1 gas, which is old, lower-priced gas. Second, there will be pressures on pipelines to reduce production of currently unmarketable block 2 gas, new, higher-priced gas.

Third, existing supplies sold in the spot market should enjoy higher levels of production. However, this may not happen if the State conservation and ratable take laws continue to hinder the pipelines' efforts to pursue a least-cost production strategy. Thus, the Commission's efforts to lower gas prices via block billing could be thwarted by State production rules.

In conclusion, the Commission has undertaken a radical restructuring of the interstate natural gas pipeline industry. Its goal of ensuring adequate long-term supplies at the lowest reasonable cost is admirable, but the basic framework requires modification and clarification to meet that goal.

Thank you.

[The prepared statement of Mr. King follows:]

STATEMENT OF
PETER J. KING, JR., CHAIRMAN
INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA
BEFORE THE
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
SEPTEMBER 19, 1985

Mr. Chairman and Members of the Subcommittee:

I am Peter J. King, Jr., Vice-Chairman of Colorado Interstate Gas Company and Chairman of the Interstate Natural Gas Association of America (INGAA). I appreciate the opportunity to appear before you today to discuss the Notice of Proposed Rulemaking (NOPR) in Docket No. RM85-1-000 issued May 30, 1985 by the Federal Energy Regulatory Commission (Commission).

INGAA is a non-profit national trade association representing virtually all of the major interstate natural gas transmission companies operating in the United States. Our member companies move natural gas from the producing areas to distributors and end users located across the nation. Approximately 90 percent of the natural gas transported and sold annually in interstate commerce flows through the more than 200,000 miles of pipeline owned and operated by INGAA member companies.

INTRODUCTION

The NOPR is the most significant regulatory proposal the Commission has ever made in relation to interstate natural gas pipelines. As stated in INGAA comments to the Commission, the NOPR is a bold, even radical, attempt to restructure the interstate gas pipeline industry with the goal being in the Commission's words, to "ensure that...natural gas markets are viably and sufficiently competitive so that consumers are provided gas at the lowest reasonable rates consistent with reliable long-term service." This stated goal is consistent with the Natural Gas Act, and the interstate pipeline industry supports it.

If this end is to be achieved, it is essential that all sectors of the natural gas industry -- producers, pipeline, distributors, brokers, etc. -- be placed in comparably competitive market positions. A careful balance is essential if there is to be fair competition and equitable distribution of the increased market risks. Consistent with this aim, incentives need to be provided all segments of the industry, especially with regard to renegotiating inflexible wellhead purchase contracts and obtaining take-or-pay relief, if in fact the fabled "playing field" is to be truly level for competition.

Although we have concerns about the appropriateness and effectiveness of the Commission's NOPR, INGAA has offered to the Commission in our comments helpful and realistic suggestions for improving the proposal.

The NOPR proposes a rule consisting of four specific proposals pertaining to billing procedures for purchased gas, take-or-pay relief, self-implementing transportation arrangements, and optional expedited certificates. INGAA's concerns as to the appropriateness and effectiveness of these proposals can be summarized as follows:

1. The Commission has not adequately substantiated the need for the block billing proposal, a major change from over forty years of regulatory, statutory and judicial history that form the foundation for the pipelines' service obligations and certificates of public convenience and necessity. Even if this change can be justified, the block pricing should be modified by allowing competitively priced, new gas to be treated as a separate block. The Commission proposal to place all new gas into a single block, regardless of the price, would severely hinder the sale of competitively priced gas and hinder the pipelines' ability to compete on an equal footing.

2. The proposed take-or-pay relief will not work because the pipelines could find it impossible to finance the buyout payments and because the producers will have no incentive to renegotiate. Unless the Commission develops a workable approach to take-or-pay, the problem will worsen, not improve.

3. The Commissions' Notice, as it pertains to self-implementing transportation, gives inadequate recognition to service obligations and long-term supply upon which pipeline systems have been designed. This is exemplified in part by the proposed right of historical sales customers to abandon sales service. The proposal also suffers from a number of practical flaws and misconceptions of pipeline operations.

4. The Commission's proposed expedited certificate procedure, while perhaps the most innocuous portion of the rulemaking, does need certain adjustments if fair competition is to be realized.

Each of these areas will be discussed in detail.

MANDATED BILLING PROCEDURE

The Commission proposed three significant changes to pipeline billing procedures:

1. three-part billing, which would be a departure from forty years of rolled-in pricing,

2. allocation of "old" gas to existing firm customers, which would be a departure from the historical system supply treatment, and

3. *de facto* deregulation of Block 2 prices, which would be a departure from traditional "just and reasonable" standards.

In the three-part billing system, block 1 would contain a pipeline's low-priced gas (about 50 percent of interstate sales), Block 2 would contain all other gas costs (about 50 percent of interstate sales) and Block 3 would contain yet to be specified other costs.

INGAA is concerned about the departure from rolled-in pricing because the interstate pipeline industry has utilized rolled-in pricing for over forty years. Innumerable contractual commitments have been predicated upon such pricing, and pipelines have designed their systems and based their acquisition programs on it. Producers have also relied on rolled-in pricing in committing funds to exploration, drilling and development for new supplies. It has also been a factual consideration in entering into gas sales contracts, and, is a judicially approved methodology.

Congress itself recognized the widespread practice of rolled-in pricing and took it into account in enacting the NGPA. In Section 208 of the NGPA, Congress mandated that Alaskan gas "shall be allocated to the rates and charges of such interstate pipeline in accordance with the general principles applicable on the date of enactment..." (emphasis added). The legislative history of Section 208, reflected in the conference report, demonstrates clearly that Congress intended by this provision to mandate rolled-in pricing. The intent of Congress in the NGPA was to encourage additional drilling of new supply sources which for the most part would be priced on a rolled-in basis. The Act has operated successfully to fulfill this intent.

In the context of the RM85-1 proceeding, the Commission has not made appropriate findings based on an adequate record to support the proposed radical departure from the existing practice of rolled-in pricing. Nor has the Commission adequately evaluated the impact of its proposal on the industry.

If the Commission does go forward with the block pricing proposal, and abandons rolled-in pricing, INGAA has recommended that the pricing structure be substantially revised in order to permit the pipelines to compete. The Commission's proposed pricing mechanism would result in a block of gas, Block 2, that is generally unmarketable under current conditions. As presently proposed, pipelines would be required to group expensive new gas sold under inflexible contracts with other new gas that is subject to market-sensitive contracts with a resulting average price of about $3.50 per MMBtu. This exceeds the price of gas in the current spot market by about $1.00. Therefore, pipelines with Block 2 gas priced above spot market prices will be hard-pressed to compete with purchasers having access to the spot market.

The competitive inequities and distortions that will arise under the NOPR are further exemplified by:

1. the ability of intrastate pipelines to continue to purchase and to sell gas on a rolled-in basis, which gives rise once again to an interstate/intrastate dichotomy which the NGPA was intended to eliminate; and

2. local distribution companies that can utilize their pipeline suppliers' facilities and old gas in competing against those same pipelines and which, unlike their interstate pipeline suppliers, can roll in that old gas with overall supply.

When these inequities are combined with the inadequate incentives for producers to renegotiate existing contracts that are not market-responsive, it is apparent that significant modification of the proposal is necessary.

In its comments to the Commission INGAA recommended the inclusion of all gas purchased under market sensitive contracts -- whether new, existing or renegotiated -- in a new pricing block or sub-block of Block 2. With this block/sub-block, pipelines would be better able to compete with new entrants or other sellers that are unencumbered by high take-or-pay or high cost contracts. Furthermore, a separate pricing block or sub-block for market-responsive gas would provide producers an incentive to renegotiate by rewarding those producers who do agree to renegotiate with increased takes and greater cash flow. INGAA's recommendation would help in the transmission of accurate price signals to producers by providing an immediate correlation between contract prices and takes of gas. This could help stimulate exploration and development during times of supply shortfall.

The NOPR appears to contemplate that all available Block 1 gas will be delivered, if requested, prior to delivery of any Block 2 gas. INGAA has recommended the Commission consider ordering pipelines to nominate on a vintage by vintage basis. However, there are a number of legal and practical difficulties associated with this recommendation including the following:

1. Industry contracts typically cover gas in more than one vintage. Block 1 gas is purchased under contracts which also cover Block 2 gas. Pipelines have not historically been able to exercise a right to require producers to deliver only Block 1 gas under these contracts or otherwise dictate delivery patterns.

2. Under many purchasing arrangements, pipelines acquire gas at the central point in a field or a tailgate of a processing plant. The gas delivered consists of a mixture of vintages produced in the field behind the plant or central point.

3. State proration and ratable take laws have historically restricted the ability of pipelines to limit their purchases of gas to specific vintages where they have contracts with producers for wells in several vintages.

There are substantial questions concerning the Commission's authority to allocate Block 1 gas only to existing firm sales customers. In addition, there is a question as to whether the proposed allocation unduly discriminates against existing interruptible customers. These customers have played an important role in the operation of pipeline systems for many years. Yet under block pricing, these same interruptible customers would not participate in the benefits of Block 1 gas, which would be made available only to firm purchasers during the historical base period. If, notwithstanding this question of authority to allocate Block 1 gas, the Commission orders it be done, INGAA has suggested the following revisions:

1. The NOPR refers to an "entitlement" on the part of existing customers' to Block 1 gas. The use of the term "entitlement" suggests an assignment of property or contract rights under gas purchase contracts to which the customers are not parties. The use of the term could give rise to claims by distribution companies that they should be able to assert control over the pipeline's gas supply or operations. INGAA therefore suggested that to avoid confusion on this issue, the term "allocation" be substituted for "entitlement", thus lending itself less to the interpretation that the customer has obtained a property or contractual right.

2. Any customer that reduces its sales contract demand should have its allocation of Block 1 gas proportionately reduced. The Block 1 gas released as a result of this reduction would be reallocated among the remaining customers of the pipeline. A customer who cancels an existing contract right and withdraws its support for the system should not continue to enjoy the benefits attendant to the status of a sales customer.

The Commission has proposed that, after four years from the effective date of a final rule, pipelines would have the flexibility to establish prices for Block 2 gas at market clearing levels and enjoy a rebuttable presumption that the resulting prices are "just and reasonable." At the same time, pipelines would bear the risk if their gas acquisition costs are greater than those reflected in their prices. Conversely, the pipeline would retain the rewards if its actual gas costs were less than its prices.

INGAA believes that the potential rewards from this proposal may prove illusory. The Commission has sought in the past to establish "just and reasonable" rates based on market forces, but the courts have not been sympathetic. For example, the United States Court of Appeals for the District of Columbia Circuit rejected the Commission's attempt to set oil pipeline rates under a "just and reasonable" standard by reliance on market forces. In another case, the Court found that "just and reasonable" rates may not be determined solely and exclusively upon the basis of market or contract prices. The foregoing decisions will have to be adequately distinguished if this aspect of the program is to be sustained.

There is also a significant unresolved question as to exactly what costs will be included in Block 3. It is also unclear how such costs will be allocated and recovered. These matters need to be clarified. INGAA submits, moreover, that the Commission has an obligation to assure pipelines an opportunity to recover their costs and earn a fair rate of return.

TAKE-OR-PAY RELIEF

Under the NOPR's buy-out/"safe harbor," the seller is asked to accept a payment effectively capped by a percentage of the pipeline's nonrecoupable take-or-pay for the two-year period 1986-1987, and in return is required to extinguish all purchase obligations over the remaining primary term of the contract. But if the contract has a multi-year term to run, it is difficult to envision why a producer would extinguish all purchase obligations, with no market assurance, in return for a payment measured by some percentage of the pipeline's nonrecoupable 1986-1987 prepayment obligation. Even if the producer agrees to such buy-outs, the elimination of all purchase obligations would result in producers demanding huge sums that would be difficult to finance and that, if paid, would likely have severe adverse financial impact on the pipeline payor. These problems are further complicated because such large buy-out payments would adversely affect the marketability of the pipeline's gas and would be detrimental to pipeline sales customers.

The current take-or-pay exposure of interstate pipelines is expected to be over $8 billion by the end of 1985; exposure through 1984 was $5 billion and 1985 exposure is estimated to be at least $3 billion. Yet the take-or-pay problem can be expected to worsen under the NOPR's proposed billing mechanism and totally inadequate take-or-pay/"safe harbor" relief mechanism. The NOPR's billing mechanism and take-or-pay relief are inextricably intertwined and if the latter fails, the former will inevitably fail. Additionally, there is nothing in the NOPR (either in the form of incentives or sanctions) that can reasonably be expected to induce producers to renegotiate existing contracts or to provide take-or-pay relief. Such incentives and relief are critical if interstate pipelines are to be able to compete in the market place.

INGAA recommended to the Commission that producers be allowed to have their gas transported under the pipeline's open access transportation tariff only after they have voluntarily granted take-or-pay relief. An additional incentive which INGAA supports would be a take-or-release mechanism whereby producers would grant take-or-pay relief in return for release of the gas and expedited abandonment. This take-or-release mechanism is similar to that provided for in the SMP orders. These incentives would go a long way toward leveling the playing field for competition.

Under current Commission policy, a pipeline may make lump sum buy-outs of problem contracts (Commission Statement of Policy, Docket No. PL85-1, issued April 10, 1985). Until now, the pipelines have been permitted either to earn on their take-or-pay prepayment investments or at least to recover carrying costs on the prepayments. Under the NOPR, however, pipelines apparently may do neither, making it extremely difficult for the pipelines to finance the buy-out.

This difficulty is best exemplified with some numerical comparisons. As noted, the 1985 exposure alone is estimated at $3 billion. The 1986 and 1987 exposure is likely to be many times greater. Since a buy-out under the NOPR would have to extinguish all future take-or-pay obligations under the remaining life of each contract, it is possible that producers would require buy-out payments exceeding the two years of take-or-pay exposure. Thus, the huge amount of money that would necessarily be involved if a pipeline were to be realistically equipped to produce the present value of its future take-or-pay revenue stream would severely strain and in some cases no doubt exceed the pipeline's borrowing capacities. For every billion dollars of buy-out, the carrying cost to the pipelines is roughly $400 million for each year of the five-year amortization period. Also, where the pipeline seeks monies to make buy-out payments but cannot satisfy the lender that the dollars can be recovered over time in the pipeline's rates, the cost of borrowed dollars, where available, can be expected to be high. Additionally, recovery of the buy-out payments will further erode the pipeline's competitive position in the marketplace.

If, as the Commission intends, pipelines are to operate on a truly "clean slate" with regard to future gas acquisition and purchase decisions, all artificial pressures presently bearing on such decisions must be eliminated. To this end INGAA offered the Commission the following specific recommendations. The existing buy-out of take-or-pay obligations should continue to be an alternative where economically feasible because the proposed buy-out/"safe harbor" clearly cannot be looked to as a panacea for the considerable problem of take-or-pay exposure confronting pipelines. For the buy-out/"safe harbor" to be useful, ceilings should not be set, and the risk of financial liability should be left to the parties through a rebuttable presumption of prudence for all safe-harbor payments. INGAA also urged that the scope of the presumption be expanded to include lump-sum payments made in satisfaction of previously incurred and outstanding take-or-pay liabilities. There should also be a continuing presumption of "used and useful" for rate-base purposes for a pipeline's gathering facilities that are "mothballed" as a result of successful take-or-pay buy-outs.

SELF-IMPLEMENTING TRANSPORTATION PROGRAM

The Commission proposes to improve access to transportation capacity on interstate pipeline systems by creating a program that permits transportation on a self-implementing basis. The Commission maintains that pipeline participation in the proposed program is voluntary, and pipelines that do "volunteer" to transport gas for others pursuant to NGPA Section 311 and/or blanket, self-implementing authority must "provide transportation service for all shippers willing to pay the applicable tariff..., without discrimination...." However, neither the standard of what is "nondiscriminatory" transportation nor the relationship with the existing standard of "unduly discriminatory" are explained.

INGAA believes that it would be more appropriate and more clearly lawful for the Commission to use the unduly discriminatory standard and to provide a notice and protest procedure to those denied transportation. Also, INGAA seriously questions just how "voluntary" this program is.

INGAA's concern over mandatory carriage is highlighted by the NOPR's provision that pipelines will have only one opportunity to get into the program and, once in, apparently will not be permitted to adjust representative volumes of capacity or get out of the program. If such is the Commission's intent, INGAA submits that the proposal is too inflexible and, to the extent abandonment is impossible, raises the question of mandatory carriage. To the extent the proposal is not voluntary, it is subject to attack as an unlawful attempt by an administrative agency to impose mandatory carriage.

A question of abandonment authority also is raised by the provision for firm sales customers to reduce their contract demand by 25% per year in any given year. In this instance, the NOPR would place de facto unilateral abandonment (termination of service) authority in the hands of pipeline customers. Even if such a delegation of authority were lawful, the proposal would prove disruptive from an operational standpoint in that sales customers could drop off a pipeline's system anytime during the year. Also, the NOPR provides that as much as 50% reduction can take place in the first few months of operating under the program (25% on November 1, 1985 and 25% on January 1, 1986). INGAA recommended to the Commission that all customers reducing their contract demand be required to do so on a single date per year. This will mitigate disruptions. Also, where a customer reduces contract demand, but does not take firm transportation service from the same pipeline, that customer should bear demand costs until a new customer is found or costs are otherwise recovered.

The NOPR provides that transportation under the self-implementing proposal will be on a firm basis. However, the proposed transportation rules are ambiguous and seem to create two classes of "firm" service. Industry practice recognizes only one class of firm service, and such service should include a demand charge relating to reservation of facilities.

The Commission further proposes to enhance competitiveness and increase the accountability of interstate pipelines as transporters of gas by establishing rates for transportation services on a volumetric basis. Minimum bills, demand charges or other mechanisms which would assure recovery of costs associated with the capacity used to provide transportation service would not be included in such rates.

INGAA recommended to the Commission that it should set all firm rates on a pipe-line-by-pipeline basis and should include appropriate demand charges relating to reservation of capacity. Where a sales customer reduces contract demand, but later wants to return to the system as a firm sales customer, reestablishment of sales services should be at the pipeline's discretion and subject to the traditional standards and certification procedures of NGA Section 7. INGAA also sought clari- fication regarding assurance that existing firm transportation arrangements will stay in place until the underlying contracts expire or roll-over. Such clarification will help to avoid unnecessary disruption.

Finally, as a matter of law and practicality, shippers or shippers' agents are not the proper parties under the NGA to file for initial service or continuation of service and they should not be permitted to do so.

The Commission's proposed transportation program could be flawed because the Commission has misperceived a major matter of historical and physical fact: most pipelines are fully subscribed on a firm basis. Thus, while there is transmission capacity on the interstate pipeline systems that is, from time to time, unused, it is the unusual case in which there is truly excess capacity. This is so because the interstate pipeline systems were designed and constructed according to particular certificated long-term service arrangements. The Commission's proposal ignores this fact and, consequently, is impracticable.

The principal difficulty in this regard has to do with the proposed class of so-called "firm" transportation service. To the extent that there may be some limited amount of firm capacity available from time to time on some systems in specific and limited locations, it is unclear just how that uncertain availability can be firmly secured for all shippers seeking transportation service.

Thus, the Commission's proposed "firm" service is physically impractical from the pipeline's point of view and it would be inherently interruptible from the firm shipper's point of view. Thus the desirability and security of such a class of service to shippers would be little or no greater than interruptible service rendered under the present Part 284 regulations.

INGAA also believes that the Commission's proposed regulations requiring no discrimination of any kind with respect to access to capacity, are an administrative impossibility. Transportation capacity varies from location to location, and from time to time, along pipeline systems. Maximum efficiency requires that pipelines be able to contract with transportation customers which will most fully and efficiently utilize the pipeline system, on either a firm or an interruptible basis. This inherently involves discrimination among customers seeking service, based upon the nature of the service sought and the operational characteristics of the system.

As an example, a prospective customer for self-implementing transportation service may be interested in capacity on a pipeline system which, if provided, would effectively "bottleneck" the pipeline's ability to render transportation service for others seeking service over greater distances and in greater volumes. If the pipeline cannot discriminate on a reasonable basis, by either requiring a greater degree of interruptibility as to the customer seeking the "bottle- neck" capacity, charging a rate (including a demand or reservation charge) commensurate with the effect of the "bottleneck" service on the pipeline's system, or refusing to enter into an agreement to provide such "bottlenecking" service, the pipeline will not be able to maximize the use of its system.

INGAA urged the Commission that rather than proscribe all discrimination, the Commission expressly incorporate into its regulations the statutory standard for access to self-implementing transportation service provided by the Natural Gas Act, which is the prohibition against undue discrimination. Applicability of the standard, should be determined on a case by case basis in accordance with established ratemaking and legal principles.

OPTIONAL EXPEDITED CERTIFICATE PROCEDURE

The optional expedited certificate procedure is intended to accomplish the broad goals of:

1. allowing pipelines greater flexibility in offering new services and changing rates where competitive forces are adequate, and

2. holding pipelines accountable and putting them at risk for their decisions to respond to opportunities presented by such flexibility.

Similar to the transportation part of the NOPR, any certificate holder providing any transportation service under the optional procedure would have to provide firm transportation service to all other shippers on a volumetric, nondiscriminatory basis. Any transportation service provided under an optional certificate would also be subject to the pipeline customers' rights to adjust contract demand. Additionally, the optional procedure would provide for expedited hearings and a rebuttable presumption that the requirements of Section 7(e) of the NGA have been met. Protestors would be given the burden of proof in demonstrating that certification would not be in the public convenience and necessity.

INGAA recommended that the Commission reconsider various aspects of its proposed optional expedited certificate procedure. The use of volumetric rates based on unchangeable estimates and the requirement of nondiscriminatory access raise the same problems discussed above in connection with the self-implementing transportation program and require similar solutions as those recommended by INGAA. Other difficulties with the optional certificate program include the treatment of demand charges and restrictions applied against the ability of pipelines to compete.

While the Commission intends the optional expedited certificate procedure to be part of a total program to foster competition, and facilitate entry, one of the proposed rate conditions would in effect discourage entry by proscribing minimum bills, minimum take provisions and demand charges, or any other provision that has the effect of guaranteeing revenue. The Commission's concern, of course, is that such provisions could have the effect of "locking in" a purchaser and preventing the purchaser from enjoying the benefits of competition and a least cost purchasing strategy.

Rather than attempting to prescribe conditions or even guidelines for optional procedure rates, the Commission should clarify its intent that parties be allowed to bargain for a rate design, including demand charges, which balances their interests in a commercially reasonable way. Given the freedom to negotiate an allocation of risks between the pipeline and the customer or user who will benefit from the project, INGAA expects many widely varying deals ranging from purely volumetric rates to instances where the customer or user may be willing to "backstop" a project to some extent to induce a pipeline to undertake the project. Although certain types of revenue guarantees may make such deals less flexible for the customer or user, they may also lead to lower prices by increasing the potential competition faced by other suppliers, both long term and short term.

Under the program proposed by the Commission, a competing pipeline, local distribution company, marketer/broker, or producer can market gas to a user on a pipeline's system on a self-implementing basis. Unlike an LDC which serves the user, the pipeline must transport the gas. On the other hand, a pipeline desiring to compete for the user's business can effectively be precluded from doing so under the prior notice - protest - hearing requirements of the optional certificate procedure. At the same time, the pipeline may be constrained by the LDC's high transportation rate. In other words, the pipeline effectively may be deprived of an opportunity to compete for the markets of local distribution companies which leave their system.

In order to truly "level the playing field" in this respect, INGAA suggested the following modifications to the optional procedures:

1. require protestors to allege with specificity sufficient facts which, if proved, would overcome a presumption of the type in proposed Section 157.104(b);

2. permit certification even if it would result in competition for and loss of business by a local distribution company (in keeping with the "competing certificate" posture of the proposed rule); and

3. limit modifications of the application and conditions on the permanent certificate to taking effect prospectively only from the time that the pipeline accepts the certificate.

CONCLUSION

The Commission has undertaken a radical restructuring of the interstate natural gas pipeline industry. Its goal of ensuring adequate long-term supplies at the lowest reasonable cost is admirable, but the basic framework requires modification and clarification to meet that goal and still have a legally sustainable rule which will produce future regulatory certainty. It is critical, furthermore, that any final rule adopted in this proceeding not inhibit interstate natural gas pipeline companies from competing for markets on equal terms with the other segments of the industry. In addition, there are numerous areas where the Commission needs to address further the operational effects of the proposed rule.

Senator NICKLES. Thank you very much, Mr. King.

Mr. Jones.

STATEMENT OF VERNON T. JONES, PRESIDENT, THE WILLIAMS COMPANIES

Mr. JONES. Thank you, Mr. Chairman.

I am Vernon Jones, president of the Williams Cos., headquartered in Tulsa, OK. I am very pleased to have the opportunity to appear in these hearings. Our company is truly a diversified company which is involved in all phases of the natural gas industry today—as a producer, as an interstate and intrastate purchaser, as a seller of natural gas, as well as a major industrial consumer of natural gas and a manufacturer of nitrogen-based fertilizers. We represent a gas market roughly equal to that represented by the State of Connecticut with all of our plants turned on.

Today I'd like to focus on our concerns regarding the proposed rulemaking. To sort of start at the top and in the interest of time, if one were to classify rulemakings by regulatory agencies as movies are classified, perhaps this deserves an *x* rating, because it, in our view, truly provides neither social nor economic benefits in its proposed form.

You have to recognize that all of us in the industry really do not know what will be in the final NOPR at this time. We will assume it is as proposed. There are a number of very important points that should be made with respect to the proposed rulemaking.

It is very untimely. We are about to enter a heating season at a time when the gas industry, gas pipeline industry, its producers and its markets are in transition and at a point in time when we are in the process of renegotiating Canadian contracts. It's a very major policy shift for the Commission.

While one might agree with the perception of some of the underlying principles of attempting to get closer to a free market situation, it would appear to be inappropriate in that further it seems to frustrate some of the intents of Congress that have been expressed both through Congress' action in the past as well as its inaction on issues dealing with things such as the deregulation of natural gas.

It undoubtedly will impact drilling. It is our belief that both oil and natural gas prices will continue to decline over the course of probably the next couple of years; however, there is no doubt that the implementation of the Block Pricing Program, as proposed in the NOPR, will exacerbate that problem and will lead to even greater declines in natural gas and oil drilling.

Since some of the benefits of drilling for oil are the production of the associated natural gas, one of the concerns you always have is the availability of markets for your associated gas production. It will create equal access problems with respect to the issues, the range of issues, that exist between the interstate pipelines, their local distribution company customers and the direct sales customers of the local distribution companies.

There is already developing quite a dialog between those various players, which includes inevitably the concerns, and the well-justified concerns, of both the pipeline and the LDC's with respect to the positions that their State regulatory agencies are going to take. I heard expressed by representatives of some of those State agencies during the testimony before the Commission itself on the NOPR their belief that they did not have the ability to cope with the access problems under the basic statutes they operate under presently in those States.

As far as the other impacts that we see, there really isn't a solution, a better solution for a mechanism to help the renegotiation of contracts between the producer and the pipeline contained in the NOPR. As pointed out in our filed statements, there is neither the stick nor the carrot for either side. In fact, we think that that is just the problem.

That process has been going forward. We as a company are very proud of the fact that we have not abrogated any contracts but have been able to move the process forward. We have still got some contracts that are problems and we think that we generally represent the industry. The industry has been doing a very good job of moving that problem on. So it doesn't help that situation.

Insofar as the ultimate impact on gas supplies in this country, I believe that it is going to send a false signal to the existing market and tend to create additional market demand that would not otherwise exist, which in turn is going to accelerate that point in time at which there is first a deliverability shortage and then ultimately a reserve shortage that will exist in this country.

It really doesn't help the development of projects like the Alaskan natural gas transportation system in that it creates greater uncertainties. It does provide an orderly market development as far as changes in price and other factors to let the pipelines contract for that gas and bring that project on in an orderly and timely fashion.

Thank you very much, Mr. Chairman. I'd be glad to answer any questions that you may have.

[The prepared statement of Mr. Jones follows:]

Vernon T. Jones

President

The Williams Companies

Subcommittee on Energy Regulation and Conservation Oversight Hearing on Federal Energy Regulatory Commission's Notice of Proposed Rulemaking

Docket No. RM85-1

September 19, 1985

Mr. Chairman, Members of the Committee, I am Vernon T. Jones, President of The Williams Companies. I appreciate the opportunity to appear before you today to discuss the impact on the gas industry of the Federal Energy Regulatory Commission's Notice of Proposed Rulemaking in Docket No. RM85-1. Williams is a diversified company which is involved in all phases of the natural gas industry today, as a producer, as an interstate and intrastate pipeline purchaser and seller of natural gas, as well as a major industrial consumer of natural gas to manufacture nitrogen fertilizers.

In my testimony today I would like to focus on the impact of this proposed rulemaking on our two interstate gas pipeline systems, Northwest Central Pipeline Corporation which operates principally in Oklahoma, Kansas, Texas, Missouri, and Wyoming, and Northwest Pipeline Corporation which operates in Washington, Oregon, Idaho, Wyoming, Colorado and New Mexico. In this regard I have attached to my prepared testimony copies of the detailed separate comments filed by each of our interstate pipelines with the F.E.R.C.

As you have heard from the F.E.R.C. and the Department of Energy in your previous hearing on the proposed rule, the F.E.R.C. has proposed far reaching and dramatic changes in the natural gas industry. In response to these proposals, we along with many others representing all facets of the industry, filed thousands of pages of comments with the F.E.R.C. detailing items of support as well as practical problems caused by the proposal. Everyone expects the F.E.R.C. to respond to these comments and to make significant changes from its initial proposal, although many disagree as to what those changes should be. In the meantime, we wait for the Commission to announce a final program, which includes the details necessary for the industry to operate with some degree of certainty of what the regulatory system expects from us.

As the sudden temperature drop here in Washington also underscores, we are rapidly approaching the beginning of a new winter heating season. The coincidence of uncertainty of what changes a new rule will have for the industry, at the same time the industry is expected to meet its heaviest load requirements and least system flexibility, is of much concern to us. We can only assume that the Commission will announce these changes later this month and expect us to be able to adjust our systems to respond to these changes by November 1.

We have watched the confusion created by the breakup of the communications industry even where significant transition periods were provided. Can the gas industry make major structural and operational changes virtually overnight and not face the same magnitude of problems when our customers expect the most from us? Only time will tell, but I would be less than candid if I said that I do not expect significant problems to arise if the Commission doesn't provide an adequate transition period to make the required changes. In my view, the bulk of any changes would be better made at the end of the coming winter heating season and not at the beginning.

We do not take issue with all the principles which motivated the Commission to issue the notice of rulemaking. We do feel, however, that the far reaching goals of the Commission cannot be accomplished by a generic rule. The gas industry is too complex to handle most the problems addressed in a manner other than on a pipeline by pipeline basis. Further, the proposed rule is unclear as to intent and meaning in many places.

For instance, while the proposed billing procedure will have significant and different effects on Northwest Pipeline and Northwest Central, the Commission's intended effect on pipeline purchase patterns is not clear for either pipeline. Possible interpretations range from "no effect" to "mandated least cost purchase policy" requiring maximum physical production of Block 1 gas without regard to contractual provisions or valid state proration and conservation rules. The Commission must clarify what it intends. We believe that Block 1 gas should be purchased at the discretion of the purchasing pipeline, functioning as a prudent operator, consistent with the need for providing reliable long-term service at competitive prices, and that Block 2 gas should be purchased at the discretion of the purchasing pipeline's customers based upon current market considerations. To do otherwise will cause operational and contract problems and run afoul of valid state laws. We also believe that the purpose of the proposal will be enhanced if Block 2 is split between gas which is priced at the wellhead on a market-sensitive basis and gas which is not market sensitive.

With regard to allocation of Block 3 costs, we also believe that the Commission must minimize the costs allocated to Block 2 gas in order to assure that the Block 2 gas is truly market sensitive at the wellhead. Furthermore, with Northwest Pipeline as a major importer of Canadian gas, we strongly support the continued as-billed flow-through of imported gas costs in the same manner as domestic gas costs. Under the three-tier proposal, this would mean that all demand costs billed to a pipeline, whether by another domestic pipeline or by a foreign pipeline, should be placed in Block 3. Placing all costs of imported gas in Block 2 would discriminate against Canadian pipelines and conflict with the goals of the Departments of State and Energy to eliminate barriers to energy trade with Canada.

Just as Northwest Pipeline has unique problems due to its heavy reliance upon Canadian gas, Northwest Central has unique problems due to the large amount of Block 1 gas on its system and its full requirements tariff which is priced at a unit commodity rate based upon end-use characteristics and which does not state a contract demand. Northwest Central's end-use tariff differs from contract demand tariffs because different sales rates are prescribed for gas depending on whether it is purchased for resale to residential, commercial or industrial users. Direct purchases and resale purchases under Northwest Central's commercial and industrial rate schedules are interruptible although the character of service is the same as "firm" contract demand service rendered by other pipelines. We believe entitlements to Block 1 gas must be fairly established among each pipeline's customers to reflect contractual obligations and rate design characteristics of the individual pipeline.

For Northwest Central's full requirements service, the formula for entitlement to Block 1 gas must be based upon a reasonable surrogate for contract demands [which do not exist on this system] and cover all uses, so as to include purchases for commercial and industrial users. Yet, as proposed, the rule may well not accommodate the unique needs of this system.

The buyout procedure proposed in the rule, although crucial to fulfilling the Commission's goals, will not be effective without significant modification. We believe the proposed rule contains disincentives to both pipelines and producers to enter into buyout arrangements. Take-or-pay obligations under non-market sensitive contracts will be substantial under the proposed rule. Pipelines cannot be expected to carry the sole burden of financing buyout costs above an arbitrary level. Producers cannot be expected to agree to buyouts if they can get the current market price from third parties through the transportation proposal and continue to pursue a contractual claim for the higher price. Nor can producers be expected to agree to renegotiate pricing provisions to market sensitive prices if take-or-pay buyout costs also have to be borne by the same market by allocation to Block 2 sales rates. The Commission's final rule must provide incentives rather than disincentives to both pipelines and producers to settle take-or-pay and contractual pricing disputes. We have made suggestions along this line in our comments.

The issue raised in the proposed rule about the allocation of take-or-pay buyout costs is an excellent example of an area where a generic rule cannot be fashioned. Due to different circumstances on each pipeline system, the customers who are responsible for take-or-pay costs or who benefit from buyouts [and therefore should bear those costs] will differ. For instance, on the Northwest Pipeline system the parties who will be responsible for the company's incurrence of take-or-pay costs will be those parties who reduce their contract demand, while on the Northwest Central system, the parties receiving Block 1 gas represent the group for whose requirements the higher priced supplies with take-or-pay obligations were contracted.

With regard to the Commission's requirement that pipelines offering non-discriminatory access must also permit sales customers to reduce contract demand, there should be regular, periodic exercise of purchase reduction options and we have made recommendations regarding the treatment of costs in rate cases. The presumption of prudence for Block 2 purchases should also be available on the same schedule as the offering of contract demand reductions.

In order to attain the goal of making pipelines indifferent as to whether they sell or transport gas, the final rule must clearly define that it is the Commission's intent that a "representative level" of volumes is one based on a realistic opportunity to attain such a volume level. We have suggested a standard that provides that the pipeline should have an equal chance of exceeding or falling short of the representative volume level.

In short, the F.E.R.C.'s proposed rule must be modified and clarified if it is to meet its objectives, and there must be some transition period during which those affected can adjust to the fundamental changes being imposed by this rule. We certainly would welcome the subcommittee urging the F.E.R.C. to adopt a final rule consistent with these thoughts.

Thank You.

Senator NICKLES. Thank you, Mr. Jones.

Mr. Smith, American Natural Resources.

STATEMENT OF S. KINNIE SMITH, JR., VICE CHAIRMAN, AMERICAN NATURAL RESOURCES CO.

Mr. SMITH. Good morning, Mr. Chairman and Senator Bingaman. I am Kinnie Smith, vice chairman of American Natural Resources Co. Our principal subsidiary, ANR Pipeline Co., serves 54 distribution companies in 9 Middlewestern States.

Senator NICKLES. Could you move the microphone up a little closer?

Mr. SMITH. We are the principal supplier of gas in the States of Michigan and Wisconsin.

We appreciate the opportunity to appear here today to express our concerns, our very grave concerns, about the effect of the NOPR not only in the pipeline industry but also on the other segments of the industry—the producers, the distributors and the consumers.

We have taken our cue from your letter, Mr. Chairman, inviting us to testify and focused really on one issue. It's not the only issue, there are many problems in NOPR, but we have focused on the issues of reliability of long-term supply and incentives for future exploration.

While we are a pipeline company and we have an overwhelming, an overriding interest in seeing gas costs reduced, we recognize in the long term our viability is determined indeed by the viability of the producing segment. Some of our testimony is going to be somewhat repetitious of what you have heard before, but we do feel that the pipelines have as great an interest in the producing segment as the producers themselves.

The block billing procedure that has been discussed before creates some very real problems. Our estimate is that the block 1 gas for our company—and I think for the Nation or most gas systems—would be approximately $1.75 per MCF. Block 2 gas would be in the range of $4 per MCF. As such, standing alone the block 2 gas would not be marketable. It would be marketable only to the extent that block 1 gas, of course, does not serve existing requirements and spot gas does not fill up some of the balance.

But that leaves as much as 3 trillion cubic feet per year of block 2 which will not find a market. The independent producer is caught in a dilemma, a true catch 22. If he has block 2 gas he will not himself, standing alone, be able to renegotiate his price to bring his pipeline purchasers' average block 2 gas down to a marketable level, to a market-clearing level, and therefore he has no incentive to go out and renegotiate his block 2 gas. His option then would be to sell it on the spot market, if he can find another buyer.

Now as you may well be aware, a pipeline such as ours and many others have proposed that there be a separate segment in block 2, sometimes called a block 2A or a fourth block, which would be reserved for market-sensitive gas, whether it resulted from new contracts or renegotiation of old contracts or even existing contracts with market-sensitive provisions.

If a producer has that option, and we propose it, he is caught on the other side of the dilemma, because it is our estimate that the market-clearing price today would be approximately $2.10 per MCF. As a production company—and our company does have a production affiliate—we have analyzed that number and it's very simple and very clear that there is no incentive to explore for gas if we are going to sell it for $2.10 and that, therefore, the producer is caught in this dilemma that will force him to either have drastically reduced revenues or sell out the balance of his existing inventory of gas at a very low price, possibly pay off his debts but have no incentive to stay in business.

The independent producer in particular is impacted because they are a late entrant into the marketplace and, like the majors, they do not have a large inventory of block 1 gas to maintain revenues over a period of time until this turns around.

All this, we believe, as the producer representative stated, will cause a drastic decline in drilling. As indicated, the EIA just reported that last year we found only 80 percent of what we produced, and this will continue, we think, for 2 or 3 years, at which point the country and certainly certain pipeline companies will be faced with very severe shortages. We will be back into curtailments.

So what we're seeing is first a downward spike in prices, followed by an upward spike, because at that time almost all gas will be deregulated. The NOPR forces both pipeline and producer to enter into only short-term contracts with this market-sensitive pricing, and a short-term contract in spot market pricing is a two-edged sword, and the second edge is aimed at the consumer and the pipeline and the distributor—the entire industry.

So we see the industry as being destabilized by the notice of proposed rulemaking and believe that the Commission should stop, look, and listen and we hope that this Congress will take steps to make sure that it does listen to the concerns of our segment of the industry.

Thank you very much.

[The prepared statement of Mr. Smith follows:]

UNITED STATES OF AMERICA
BEFORE THE
UNITED STATES SENATE
SUBCOMMITTEE OF ENERGY REGULATION AND CONSERVATION

Regulation of Natural Gas
Pipelines After Partial
Wellhead Decontrol

ORAL STATEMENT OF
S. KINNIE SMITH, JR.
VICE CHAIRMAN
AMERICAN NATURAL RESOURCES COMPANY
UNITED STATES SENATE
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
SEPTEMBER 19, 1985

Mr. Chairman and Members of the Senate:

I am S. Kinnie Smith, Jr., Vice Chairman of American Natural Resources Company. Our wholly-owned interstate pipeline, ANR Pipeline Company, serves some 50 gas utility distribution customers in nine Midwestern states, principally in Michigan [illegible] Wisconsin.

We are deeply concerned about the Federal Energy Regulatory Commission's Notice of Proposed Rulemaking (NOPR), and appreciate this Subcommittee inviting my Company to express it's views.

Some 45 million homes are heated with gas. Over 10 percent of the total electricity generated in the U.S. is by gas with that figure approaching 75 percent in some states. Most government and public buildings such as hospitals, nursing homes, and schools are heated with gas. The reliability and stability of natural gas supply, therefore, is critical to these consumers due to the lack of immediate alternatives.

Any major changes in the regulatory environment which affect gas supply should be carefully considered by the FERC before it takes final action. This is particularly true in the case of the NOPR which all parties believe will have sweeping consequences for all segments of the industry, that is producer, pipeline and distributor. It is entirely appropriate for the Subcommittee to be concerned about these consequences even though it is a matter pending before the Commission.

In response to the Chairman's request that we pay particular attention to supply reliability and the effect on exploration for new gas supplies, I will limit our statement to these matters even though the NOPR presents other problems for interstate pipeline companies such as ours.

While we and other pipeline companies have an overriding interest in lowering our cost of gas, we cannot ignore the effect of the NOPR on gas producers. They are our "life blood." It is obvious to all that long-term viability of the producing segment of the industry will directly affect the pipelines' future gas costs, their ability to meet customer needs and their competitive position. We think the focus of the Subcommittee's attention is entirely appropriate.

The NOPR proposes to split gas into two tiers for rate purposes. This provision is mandatory, not optional as other NOPR proposals allegedly are. The first tier is "old" regulated gas which by 1990 will amount to less than 15 percent of total supply. The second tier will be primarily from deregulated sources. Industry estimates indicate that tier one gas will be priced in the range of $1.75 per Mcf and tier two gas in the range of $4.00. If so, the tier two gas will be marketable only to the extent that requirements exceed available supplies of tier one gas and any spot gas purchases. The balance of the tier two gas will not be sold. Contract purchases from producers will have to be cut back to fit the reduced markets. Moreover, the amount of unsold tier two gas will be increased if state public service commissions separately price tier one and two gas and allocate the high priced tier two gas to price sensitive markets. This marginal pricing of tier two gas at the retail or user level could cause the distributor to lose markets. Industrial customers, for example, would be lost to competing fuels, such as imported residual fuel oil. On a national basis, the lost gas market could amount to as much as 3 trillion cubic feet. The threat is not idle. In the State of Michigan new arrangements are being developed by the Public Service Commission and local distribution companies which effectively allocate marginally priced tier two gas to certain commercial and industrial customers.

Therefore, if the FERC's final regulations retain the two tier pricing proposed in the NOPR, producers and pipelines alike will lose markets unless the producers renegotiate lower prices. But this would require all producers to act in unison since no single producer can bring a particular pipeline's tier two gas price down by a meaningful amount. As a consequence, it is impractical to think that the tier two price will be reduced to market clearing levels. Many producers will be caught in a dilemma. On one hand, they cannot remain financially viable if they renegotiate all of their contract prices down to today's marginal price of about $2.10 per Mcf. This is particularly true of the smaller independent producers which, unlike the major companies, do not have significant inventory of low cost tier one gas to maintain the revenue stream to service debt and continue operations. On the other hand, if they do not renegotiate lower prices, gas markets will shrink with the same negative results for the producer.

While we and other pipelines favor a separate tier for new and market sensitive gas contracts as a means to increase the flow of lower, marginally priced gas to market, this option does not solve the financial problem for the independent producers. A wellhead price of $2.10 per Mcf will not be enough to encourage sufficient new gas exploration. The independent producer will be effectively put out of business.

On a national scale, one only needs to examine U.S. gas well drilling activity to become convinced that a tighter supply situation is already predictable for the near future. Compared to 1981, seismic crews in 1985 are down 42%, active rigs are down 48%, gas well completions are down 35%, and exploratory gas wells are down 40%. Proven U.S. gas reserves have fallen and will continue to do so, particularly in light of falling world oil prices. A recent report of the Energy Information Administration confirms that gas reserves dropped last year to a new low of 197.5 trillion cubic feet, with 1984 new discoveries amounting to only 79% of production. The NOPR will accelerate this trend.

Current production, therefore, is coming increasingly from existing reserves. If this escalates under NOPR as we predict, it will have the effect of steepening the decline curve of this reserve base and will rapidly deplete today's "gas bubble" of excess deliverability.

When the excess is eliminated and the tight supply situation arrives, the production lag associated with exploratory drilling may cause supply disruptions similar to those experienced in the 1970's.

This time, however, the situation will be much more complex. In the early 1970's there was one basic regulatory agency, the Federal Power Commission, 20 plus major U.S. pipelines, and 200 or so large distributors. Allocation of the available supply in that environment was difficult with some plans taking 5-7 years to reach approval stage. Allocation was manageable, however, because the pipelines essentially were the buyers and sellers of gas and the "fix" could be applied by one regulatory agency through a relatively small number of pipelines to a limited number of major distribution companies. The NOPR will cause the pipelines to become transporters for the most part, with their own gas accounting for only a small portion of the total supply. The FERC will have an infinitely more difficult job of sorting out high and low priority end uses and exercising their jurisdiction to weight and balance them as a necessary part of determining curtailment priorities. As a consequence, the Congress will then be saddled with the burden of allocating supplies to hundreds of distributors and thousands of individual buyers ranging from factories to schools, each one potentially a unique and worthy case.

By the time the shortages have occurred, most gas will be deregulated at the wellhead. The NOPR's marginal pricing scheme will lead to spot market pricing and short-term contracts with neither the producers nor the gas purchasers (whether pipelines or end users) are assured of long-term supply or pricing consistency. We can then expect a rapid increase in gas prices. Consumers will then realize that long term contracts benefit them just as long-term investors in pipeline securities have for many decades. To answer the Subcommittee's direct question, the NOPR will not provide reliable long-term supply of natural gas at the lowest possible cost. With shortages predictable even without the NOPR regulations, the thrust of NOPR toward spot pricing and short-term contracts is short-sighted and in the wrong direction. We should not forget that only a few years ago new contracts (the equivalent of today's spot gas) priced gas in the $7 to $9 per Mcf range--far in excess of the prevailing rolled-in price under existing long term contracts.

Not only will a future "price spike" be a distinct possibility as a result of the move toward spot pricing and short term contracts, but the change of the interstate pipelines to transporters of gas, as distinguished from buyers and sellers, will have a significant effect. Today interstate pipelines have a service obligation to their customers that leads them to manage their gas supply to meet this obligation. This has resulted in pipelines purchasing gas under long-term contracts and at times acquiring gas for future periods even though they have adequate deliverability at the time they enter into the contract. This entails risk and, at times, mistakes are made when future markets are below expectations. We have just been through a period when many pipelines contracted for gas in excess of their actual requirements and at prices in excess of current market clearing prices. But the industry is working its way out of these problems through arms-length negotiations. The question must be asked isn't the risk of this type of over protection for future supply better for the consumer than a short-term approach wherein the pipeline assumes no responsibility for future service? The answer is obviously "yes." We believe that the Commission should not bring about this radical a change in the natural gas industry without making a more in depth investigation into the consequences of the NOPR and guidance from the Congress.

We believe that the interest of the general public that depends on the current natural gas system would be best served by retaining the existing regulatory framework which can be modified less radically to meet particular problems. Sweeping changes of the type proposed by the Commission in the NOPR should come from the Congress.

Senator **Nickles**. Thank you very much, Mr. Smith.
Mr. Morris of El Paso.

STATEMENT OF RICHARD S. MORRIS, PRESIDENT, EL PASO NATURAL GAS CO.

Mr. **Morris**. Mr. Chairman, thank you very much.

It's a pleasure for us to appear here today. We appreciate the opportunity. I am Richard Morris, president of El Paso Natural Gas Co. El Paso buys its gas supplies principally in the States of Oklahoma, New Mexico, and Texas and we sell that gas and transport gas that we handle for third parties to customers in the States of Texas, New Mexico, Arizona, Nevada and California, California being our principal market.

We have filed comments addressing the specific questions that the subcommittee is interested in, but I would like to focus very briefly on two major points. First of all, we believe that the NOPR is a very disruptive mechanism and the irony and perhaps tragedy of it is that it is unnecessary.

In the area of transportation, I think that throughout the gas transmission industry, and certainly on the El Paso system, we are today transporting substantial quantities of gas, including spot market gas, including gas that is released from our contracts so that it can enter the market, and we're doing this in response to market forces.

We're not doing this in response to either legal or regulatory compulsion. We are well on our way to meeting the needs of our distribution customers and our direct sales customers through transportation on a voluntary basis. Today out of approximately 3 billion cubic feet a day of throughput approximately a third of that is transportation gas on our system.

The second point I want to make has to do with the high-cost gas problem. It is still a problem, but we are making inroads on it. We have renegotiated a very substantial portion of the high cost gas that has plagued our system, and again I think that's fairly typical of the industry. The NOPR already is casting a cloud on these renegotiating efforts. We are still carrying on a dialogue with our producers, but we have not concluded any renegotiations of problem contracts since the NOPR surfaced, and I suspect that until the rules are completely clear that that will continue to be the case.

I think the uncertainty, the disruption that's going to result from the issuance of the NOPR is going clearly to provoke a maelstrom of litigation, litigation between pipelines and the high-cost producers or the high-cost--concerning the high cost contracts that still exist that do not have market-sensitive provisions in them.

I see no alternative but extensive litigation and it's small comfort that we will have a lot of company in the courthouse.

So far we have not had to abrogate any of our contracts, nor have we had to declare conditions of force majeure on our system. We are proud of that and would like to continue that as long as we can. Given the NOPR, I don't see how that could continue into the future.

Also, as others have observed, there would certainly be litigation concerning the effect of State prorationing and ratable take laws because they do seem inconsistent with the necessary results of the NOPR.

Mr. Chairman, thank you very much. That's all I will have to say.

[The prepared statement of Mr. Morris follows:]

Statement of
Richard S. Morris, President
El Paso Natural Gas Company
Before the
Subcommittee on Energy Regulation and Conservation
Committee on Energy and Natural Resources
United States Senate
September 19, 1985

Introduction and Preliminary Observations

Mr. Chairman, Members of the Subcommittee, my name is Richard S. Morris, President of El Paso Natural Gas Company. I appreciate the opportunity to appear before the Subcommittee today to present El Paso's views on the Federal Energy Regulatory Commission's Notice of Proposed Rulemaking in Docket No. RM85-1-000.

El Paso is a wholesale supplier of natural gas to utilities and direct sale customers in the states of Texas, New Mexico, Arizona, Nevada and California. Our principal supply areas are located in the states of Oklahoma, Texas and New Mexico.

By letter dated September 9, 1985, the Subcommittee requested comments on four separate, but related issues. El Paso will respond specifically to the Subcommittee's inquiries, but at the outset, El Paso wishes to make several brief, general observations concerning the NOPR and its probable impact.

Against a background of comprehensive state and federal regulation from the wellhead to the burnertip, the natural gas industry has passed through some turbulent times, first in managing the serious supply shortages of the 1970's and now in managing a surplus that began a few years ago and is expected to continue for the forseeable future.

The FERC by means of the NOPR now proposes to administer still another shock by attempting a total restructuring of the industry just as it appears to be achieving some success in dealing with the necessary market reordering that results from excess supplies. El Paso does not disagree with the Commission's stated objectives of encouraging fair competition in natural gas acquisition and marketing. They are commendable but, in El Paso's view, the NOPR proposes radical surgery to a patient already on the road to recovery. Nonetheless the rulemaking is now on the table and El Paso believes that the Commission should proceed to an expeditious resolution of these issues in order to remove the uncertainties and paralysis that now pervade the industry. We are hopeful, however, that in arriving at its decision on this important matter, the Commission will seriously consider the concerns raised by El Paso and other parties to the proceeding.

Response to Specific Questions

1. Would the public interest be better served by retaining the existing regulatory system?

El Paso recognizes certain inefficiencies and inadequacies in the existing regulatory structure. Unfortunately, however, the NOPR proposes changes to certain aspects of the structure which, in El Paso's view cannot be altered without causing drastic market disruption.

Specifically, El Paso is opposed to the NOPR's proposal to abandon rolled-in pricing in favor of mandatory block pricing and to force changes in El Paso's existing sales tariffs and rate schedules. El Paso opposes these changes which will alter the structure and substance of El Paso's jurisdictional sales.

All natural gas transmission companies' gas acquisition practices, including those of El Paso, have been directly linked to, and directly dependent upon, continuation of rolled-in pricing. The NOPR's proposed abandonment of rolled-in pricing will render many of El Paso's gas purchase contracts -- insofar as those contracts provide for the sale of Block II gas -- commercially impracticable, and will frustrate the intent of the contracting parties through alteration of a fundamental assumption upon which these contracts were originally executed -- i.e., continuation of rolled-in pricing. And, the resulting litigation will be extensive, expensive and, most unfortunately, unnecessary.

Dislocation and disruption of gas industry contractual relationships, which have their genesis in fifty years of rolled-in pricing, is not consistent with the public interest. If the Commission proceeds with mandatory block pricing, it must do so with a clear understanding of the effects of such government action on existing gas purchase contracts, and a clear expectation that massive private party litigation will ensue.

Similarly, the proposed take-or-pay safe-harbor provision will exacerbate, rather than remedy, the existing market problems which have developed during this era of over-supply. This facet of the NOPR is especially ill-advised given the recent progress which El Paso and others in the industry have achieved in renegotiating high-cost ("problem") contracts. El Paso fully recognizes the seriousness of the market disorder caused by such problem contracts, and is not attempting to minimize or understate its severity. Nonetheless, El Paso believes that the steady progress made to date is indicative of the industry's inherent ability to self-correct. The Commission should not interfere with such progress in the absence of a more effective alternative solution; the NOPR does not offer such a solution.

El Paso is likewise of the view that the present regulatory framework governing pipeline transportation should be left intact. A significant percentage of El Paso's current through-put is transportation gas, most of which is moving to existing distributor customers. While this transportation displaces El Paso's own sales gas and is therefore creating additional take-or-pay problems, El Paso nonetheless is mindful of the desires of our customer companies and their respective state commissions to take advantage of the relatively low spot prices available as a direct result of the current gas supply surplus. We are presently accommodating this desire through transportation arrangements with our customers. At the same time, it is important to balance the benefits of this relatively cheap spot-market gas against the need to maintain the viability of our long-term supplies which underlie our gas sales obligations.

2. Would the NOPR create a regulatory system that would be operationally workable and legally sound?

As suggested in response to Question 1, certain of the radical changes proposed under the NOPR are neither operationally workable nor legally sound.

a. Operational Considerations

From an operational perspective, the NOPR contains major impediments. For example, little or no consideration appears to have been given to the probable effect of the laws and regulations of both producing and consuming states on the implementation of block pricing.

Specifically, the Commission's NOPR does not address the results of the proposed pricing regulations if state regulatory commissions follow, or fail to follow, the Commission's lead in requiring tiered pricing to preserve the benefits of low-cost gas supplies for an identifiable customer class of the local distribution companies. If the state commissions fail to follow the FERC's lead, all that will be accomplished will be the deliverance of the pipeline's below market priced Block I gas into the hands of the local distribution companies where, if it is so inclined, the state commission may allocate such low cost supplies in any manner it sees fit. Furthermore, numerous other questions are left unanswered respecting the probable impact on the proposed tiered pricing regulations of present state laws affecting pipeline wellhead purchases, such as common purchaser, priority of purchase, pro-rationing, and ratable take laws and regulations. These questions and others apparently have been overlooked by the Commission.

b. Legal Considerations

The legal impediments standing in the way of implementation of the NOPR are more fully discussed in the attached legal analysis which was originally submitted as part of El Paso's comments filed with the FERC in Docket No. RM85-1. For the benefit of the Subcommittee, El Paso will briefly summarize what it considers to be the NOPR's fundamental legal infirmities.

First, with respect to the NOPR's block-pricing scheme, the Commission has failed to justify satisfactorily the reasons for the proposed departure from rolled-in pricing and, in this regard, has not complied with the standards prescribed under Section 5(a) of the Natural Gas Act. As a condition precedent to implementation of the block pricing proposal -- and the unilateral modification of existing pipeline tariffs -- the Commission must first find and affirmatively state that the rolled-pricing structure reflecred in existing tariffs is unjust, unreasonable and unduly discriminatory. Since the Commission has not (and, practicably, cannot) declare -- as it did in Order No. 380 with respect to minimum commodity bills -- that rolled in pricing is unjust, unreasonable and unduly discriminatory, it may proceed to alter this aspect of pipeline ratemaking only on a case-by-case basis and only in a manner otherwise consistent with the standards of Natural Gas Act Section 5(a).

Secondly, the NOPR provision which requires allocation of low-cost Block I gas based on historical takes for years 1982-1984, is legally untenable inasmuch as it unduly discriminates among a pipeline's customers based on when such customers attached to the system. Such preferential rate treatment, based simply on historical accident, is inconsistent with the principles underlying the Commission's long-standing adherence to rolled-in pricing and otherwise contravenes Sections 4 and 5 of the Natural Gas Act.

Thirdly, the Commission's reliance on competitive market forces to determine the prices which consumers will pay for their gas, represents an abdication by the Commission of its duty under Sections 4 and 5 of the Natural Gas Act to protect consumers from unjust and unreasonable rates. Court decisions handed down as recently as last year have specifically rejected wholesale reliance on competition as a means by which the Commission may set just and reasonable rates.

Finally, the NOPR's Block I entitlements feature represents an impermissible attempt by the Commission to regulate pipeline direct sale rates. Although El Paso agrees that firm direct sale customers should be entitled to an allocable portion of Block I volumes, the price charged for such volumes is subject only to the contract between the parties. The Natural Gas Act, and the cases decided thereunder are clear: the Commission is without authority to regulate, either directly or indirectly, the rates charged by an interstate pipeline to a direct sale customer. Accordingly, the proposed attempt (through the block-pricing scheme) to regulate the rates charged for gas sold to direct sale customers -- whether such volumes represent the direct sale customer's Block I entitlement, or derive from Block II -- is outside the Commission's rate-setting authority under Sections 4 and 5 of the Natural Gas Act and beyond the jurisdictional reach of Section 1(b) of the Natural Gas Act.

3. Would the NOPR create a regulatory system that would assure residential, commercial and industrial consumers a reliable long-term supply of natural gas at the lowest possible cost?

Contrary to its stated objectives, the NOPR cannot and will not establish a regulatory system which will produce desired long-term price and supply improvements. In fact, El Paso submits that while the NOPR may not cause immediate short-term price increases -- since gas rates will be determined by the market place in any event -- its long-term implications may substantially impede future exploration and development initiatives with resultant increases in costs.

For example, under the NOPR block pricing proposal, Block II supplies in the three block pricing scheme will be priced higher than alternative fuels such as fuel oils and therefore will be unmarketable and will remain so unless substantially all non-market sensitive contracts can be renegotiated or the force majeure provisions of such contracts become operable because of the Commission's action. One possible consequence of this action could be a massive displacement of domestically produced natural gas with imported oil. The block pricing proposal could be improved by creating an additional block for market sensitive gas which would not penalize those producers who have negotiated or renegotiated contracts to be responsive to market conditions. Even so, the pipeline would still be left with an inventory of non-market-sensitive gas under the remaining block which could not be sold and on which it will continue to accrue take-or-pay obligations.

Finally, the NOPR does not consider the incremental capital costs associated with its underlying policy objective of shifting more market-risk onto the pipeline companies. By changing the "rules of the game" -- particularly in outlawing rolled-in pricing -- the NOPR clearly increases the risk borne by all classes of pipeline company investors and, as such, will raise the cost of capital paid by pipeline companies in the future in order to attract the capital required both to maintain the integrity of the existing interstate network as well as to expand into new supply and/or market areas.

The NOPR's take-or-pay buyout provision contemplates total elimination of pipeline take-or-pay obligations. As currently proposed, the provisions would only permit an as yet unspecified percentage of a maximum two years of take-or-pay payments determined to be unrecoupable, to be recovered on an unspecified basis over a five-year period. No carrying charges would be allowed to be collected on the amount of take-or-pay payments actually financed by a pipeline. Although, El Paso sees little possibility of producers consenting to take-or-pay reductions based only on a two-year calculation of unrecoupable amounts, El Paso is even more skeptical that these payments (which presumably could be very large relative to the net worth of individual companies) could be financed by third party lenders unless the recovery of principal was guaranteed through a minimum bill and at least some type of return (presumably a debt return) was allowed on the unamortized balance. This, however, assumes that future lenders can be convinced to rely on regulatory policies which the FERC is showing through the NOPR it can change anytime at its sole discretion.

Should the buy-out provisions prove to be ineffective in solving high-cost problem contracts, as El Paso fully expects, the risk of extensive market loss by the pipelines under the NOPR's tiered-pricing requirements cannot be ignored; major financing and financial market impacts must be anticipated.

4. What impact would the regulatory system the NOPR proposes to create have on exploration for new gas supplies, and production from existing gas reserves?

The NOPR will not encourage producers to increase exploratory drilling and probably will result in a reduction of drilling activities. While producers may, under the NOPR, have more incentive to shop around for markets for their surplus gas, this is not to be equated with an incentive to explore for new gas reserves. Moreover, the pressure to abandon or substantially revise the entire NOPR framework will be compelling in a gas shortage situation. The NOPR is totally devoid of any support for the assertion that this framework will be stable and viable under shortage conditions. Today, under conditions of surplus, the consumer is not complaining. But today's surplus and falling prices are already manifesting themselves in reduced exploration and drilling activity, and is thereby sowing the seeds of tomorrow's shortage and higher prices. The consumer will not long benefit from this proposition.

Conclusion

The NOPR will not achieve its intended goals of restoring market order to the natural gas industry. To the contrary, severe industry-wide disruption is inevitable. Extensive litigation is certain to ensue between pipelines and producers concerning Block II contract disputes, take-or-pay suits, state conservation laws and royalty owner claims. Incremental capital costs, future supply uncertainties, and long-term price increases will serve to compound the problems. Suits challenging the legality of the NOPR will undoubtedly be filed and, pending their resolution, the industry will reside in a posture of uncertainty and suspense.

El Paso is confident of the industry's ability to continue to solve the remaining inefficiencies resulting form a supply surplus, given sufficient time and limited regulatory interference. El Paso thus far has been reasonably successful in managing supply problems through renegotiations with its producer-suppliers. The proposed rulemaking has created such uncertainty that these negotiation efforts are currently stalled. Ironically, implementation of NOPR may undo these positive efforts, with no offsetting benefits.

Thank you for the opportunity to present El Paso's views on this important subject.

ATTACHMENT A to
Comments of El Paso
in Docket No. RM85-1

Legal Issues

I. The Commission's Proposed Three-Tier Billing Structure Cannot Lawfully Be Adopted

The NOPR at p. 115 *et seq*. proposes to abandon rolled-in pricing and to implement in lieu thereof tiered-pricing. As discussed below, the Commission has failed to justify satisfactorily the reasons for the proposed departure and has not complied with the standards prescribed under Section 5(a) of the Natural Gas Act.[1]

Rolled-in pricing, as applied to both facility and gas costs, is firmly entrenched in Commission ratemaking.[2] Under this principle, the costs associated with expanding the physical plant or adding system gas supply are combined with past costs and taken as a whole for cost allocation and rate-making purposes. The rationale behind "rolled-in" pricing follows from the well-established regulatory precept that a pipeline's facilities and gas supply constitute an integrated system serving all customers rather than a specific customer or customer group.[3] In addition, rolled-in pricing has been commended as a rate-making tool which facilitates new gas supply acquisitions and system expansions to the ultimate benefit of all the pipeline's customers.[4/] Finally, rolled-in pricing has the recognized virtue of according equal treatment for customers receiving equal service.[5/]

---

[1] El Paso notes that the arguments presented herein address the infirmities of tiered-pricing as tested under the standards prescribed by the Natural Gas Act of 1938, as amended. El Paso does not consider, however, the extent to which the block-pricing scheme may violate the NGPA and, specifically, Title II, which is arguably the only lawful departure from rolled-in pricing.

[2] *See* Battle Creek Gas Co. v. F.P.C., 281 F.2d 42 (D.C. Cir. 1960).

[3] *Id*. at 46.

Although from time to time the Commission has sanctioned exceptions to rolled-in pricing, it has done so only upon a clear showing -- on a case specific basis -- that adherence would produce unfair and inequitable results and only where the traditionally-recognized benefits of rolled-in pricing would, under the facts, be frustrated or impaired by its implementation.[6/] In this respect, in rare instances where new, discrete facilities are built or gas supplies are acquired for the sole and exclusive benefit of a single customer or customer class, the Commission has ordered that the costs associated with such facilities or supplies be incrementally charged (rather than rolled-in) to the beneficiaries thereof.[7/]

4/ Cf. Northwest Pipeline Corp., 23 FERC ¶ 63,079, 65,244-5 (1983), affirmed in part, Opinion No. 213, 27 FERC ¶ 61,012 (1984).

5/ Battle Creek, 281 F.2d at 46-7.

6/ See Colorado Interstate Gas Co., 19 F.P.C. 1012, 1021 (1958), departing from rolled-in pricing upon a finding that adherence thereto would discourage the pipeline from acquiring new supplies of gas and deter market expansions.

7/ See e.g., The Montana Power Co., 11 F.P.C. 1 (1952).

The NOPR's three-tier billing structure, if adopted, will work a complete and radical overhaul of fundamental principles of pipeline rate regulation. This radical departure from past practice may be accomplished, if at all, only if accompanied by adequate explanation and justification.[8/] Moreover, when the Commission attempts to alter rates, or modify approved tariffs by rulemaking rather than case-by-case adjudication, the standards of Section 5 are nevertheless applicable.[9/] Accordingly, as a condition precedent to implementation of the tiered-pricing proposal -- and the unilateral modification of existing pipeline tariffs -- the Commission must first find and affirmatively state

---

8/ Mississippi Valley Gas Company v. FERC, 659 F.2d 488, 506 (5th Cir. 1981).

9/ *See e.g.*, Shell Oil Co. v. F.P.C. 520 F.2d 1061 (5th Cir. 1975), *cert. denied*, 426 U.S. 941 (1976); *see also* Order No. 380-C, III FERC ¶ 30,607 at 31,189 (1984); *see also* Order No. 380, III FERC ¶ 30,571 at 30,971-72 and n.53.

In addition, the Commission arguably suggests that the Commission may subsequently alter the terms of a certificate, including the commitment of capacity, without the consent of affected parties. *See*, *e.g.*, NOPR mimeo at 21, 22 (NGA "Section 5(a) has been interpreted as giving the Commission authority to alter the terms and conditions of certificated service even though the affected parties, acting alone, could not have changed them"). Any Commission implementation of involuntary modifications to pre-existing levels of certificated sales and transportation service, including claims to pipeline capacity (*see e.g.*, NOPR mimeo at 23 n.42 (stating that "preexisting arrangements would be 'grandfathered' under the proposed rules")), would be impermissible, however. *See*, *e.g.*, United States v. Seatrain Lines, Inc., 329 U.S. 424, 432-33 (1947). Therefore, El Paso respectfully urges that the Commission, in the final rulemaking, clarify its intention not to attempt to adversely alter previously certificated service levels without the consent of the parties.

that the rolled-in pricing structure reflected in existing tariffs is unjust, unreasonable and unduly discriminatory.[10] As a practical matter, it may well be impossible for the Commission to find and declare that continuation of rolled-in pricing on *all* pipeline systems results in unjust and unreasonable rates.[11] Indeed, just earlier this year in *Texas Eastern Transmission Corporation*, 30 FERC ¶ 61,144 at p. 61,264 (1985), the Commission reaffirmed its long-standing adherence to rolled-in pricing based on its finding that the pipeline's system was fully integrated and because all the pipeline's customers share equally in the benefits of system gas supply. The Commission stated:

10/ *See* Order No. 380, at 30,961-65. The NOPR pays lip-service to the powers of the Commission under Sections 5 and 16 of the Natural Gas Act to modify rates, even by rulemaking, which are unjust, unreasonable and unduly discriminatory. However, except to state its objectives of "leveling the playing field" and facilitating the transmission of market-signals, the Commission wholly fails to satisfy the Section 5(a) standards with respect to an explanation or justification for abandonment of rolled-in pricing.

11/ *Compare* the NOPR Block-pricing feature with Order No. 380 in which the Commission modified, on a generic basis, pipeline minimum bill provisions to the extent such provisions operated to permit recovery of unincurred variable costs. In Order No. 380, the Commission observed that minimum commodity bills which include variable costs of which the pipeline may or may not ultimately have to pay out are "on their face" unjust and unreasonable. *Id*. at 30,962.

> Where a pipeline system is operated on an integrated basis, *we see no justification for separating specific gas supplies to specific customers*.

Id. (emphasis added).

Accordingly, El Paso submits that abandonment of rolled-in pricing may be properly ordered only on a case-by-case basis and only upon a demonstration by the Commission that the rates produced under rolled-in pricing are unjust, unreasonable and unduly discriminatory.[12] Moreover, any such finding must be supported by substantial evidence as regards to each pipeline to which the Commission intends to impose the rule.[13] Stated differently, although El Paso does not contest the authority of the Commission under Section 5(a) to effect rates or tariffs on a generic/ rulemaking basis, El Paso submits that the requisite Section 5(a) findings -- *i.e.*, rates which are unjust, unreasonable or unduly discriminatory -- must first be made (and supported by substantial evidence) regardless of whether the Commission chooses to act generically or case-specifically. By definition, however, generic action will have a broader impact than case-by-case adjudication and, consequently, the burden on the Commission is more onerous: that is, the Commission must demonstrate, by substantial evidence, that rolled-in pricing no longer produces just and reasonable rates, and that block-pricing will produce just and reasonable rates, as regards to every pipeline system ordered to make the conversion from rolled-in to block pricing. The review undertaken to date by the Commission in Docket RM85-1 cannot possibly satisfy the "substantial evidence" standard necessary to support a generic, unilateral departure from a fundamental ratemaking principle consistently endorsed by the Commission for over forty years. 14/ Since the Commission has not (and cannot) declare -- as it did in Order No. 380 with respect to minimum commodity bills -- that rolled-in pricing is facially or *per se* unjust, unreasonable, and unduly discriminatory, it may proceed to alter this aspect of pipeline ratemaking only on a case-by-case basis and only in a manner otherwise consistent with the standards of NGA Section 5(a).

---

[12] *See* F.P.C. v. Texaco, 377 U.S. 33 (1963), *reh'g denied*, 377 U.S. 984 (1964), upholding Commission regulations promulgated by rulemaking due, at least in part, to the fact that the regulations did "not pass on the merits of any rate structure . . . " and that, therefore, generic rulemaking was appropriate, *later app. sub nom.* Southern Natural Gas Co. v. F.P.C. 547 F.2d 826, *motion granted*, 565 F.2d 871 (5th Cir. 1977)

[13] *Cf.* Section 19(b) of the Natural Gas Act and F.P.C. v. Hope Natural Gas Co., 320 U.S. 591 at 600 (1944). *See also*, Louisiana Power & Light Co., 526 F.2d 898 (5th Cir. 1976).

14/ Indeed, the comments filed in response to the Commission's earlier NOI's show considerable support for continuation of rolled-in pricing at every level of the gas industry. *See e.g.*, Comments of the American Gas Association (national trade association composed of nearly 300 natural gas distribution and transmission companies); Comments of Grocery Manufacturers of America (trade association process gas users involved in manufacturing of grocery products throughout U.S.); Comments of NI-Gas Company (an Illinois local distribution company); Comments of INGAA; and Comments of Indicated Producers, all in support of continuation of rolled-in pricing.

II. The Proposed Allocation of Low-Cost Gas Supplies Unduly Discriminates Between Pipeline Customers

Related to the issue of block-pricing is the provision in the NOPR concerning the allocation of a pipeline's gas supplies. Specifically, the NOPR provides that Block I, low-cost gas will be allocated based on the actual takes by firm customers during years 1982, 1983 and 1984. As next discussed, this provision is legally untenable inasmuch as it unduly discriminates among a pipeline's customers based on when such customers attached to the system.

Under the NOPR, as presently structured, a firm customer who attached to the pipeline's system in 1982 would, by virtue of having purchased more total gas in years 1982, 1983, and 1984 be entitled to greater volumes of lower-priced Block I gas than a customer who attached in 1983 or 1984 and whose average annual purchases were equal to (or even greater than) that of the existing (1982) customer. Such preferential rate treatment -- based simply on historical accident -- is inconsistent with the principles underlying Commission adherence to rolled-in pricing[15] and otherwise contravenes Sections 4 and 5 of the Natural Gas Act.

As the Commission has observed, a pipeline may have separate sets of criteria with respect to new and existing customers; however, such distinctions are permitted "only as long as the difference does not embody undue discrimination against either group."[16] Thus, although an allocation of gas supplies based on end-use considerations has, during curtailment situations, been found to be permissible,[17] at no time have the Commission or the courts sanctioned discrimination among existing customers based on a first in time, first in right theory.[18] Proponents of incremental pricing (as opposed to rolled-in pricing) have throughout the years attempted to advance the theory that price discrimination between older and more recent customers of the

---

[15] See Battle Creek Gas Co. v. F.P.C., 281 F.2d 42, 44-47 (D.C. Cir. 1960).

16/ Consolidated Gas Company of Florida v. Florida Gas Transmission Co., Opinion No. 225, 28 FERC ¶ 61,350 at 61,638 (1984).

17/ Consolidated Edison Co. of New York v. FERC, 676 F.2d 763 (D.C. Cir. 1982).

18/ In Algonquin Gas Transmission Co. v. F.P.C., 534 F.2d 952 (D.C. Cir. 1976), the Court, in dicta, indicated that the Commission could require Algonquin to curtail its new customers exclusively rather than using a pro-rata plan. But, in *Algonquin*, the pipeline had requested authority to sell excess gas to the proposed new customers and, as the court noted, "it is a contradiction in terms to create excess gas by taking some of it away from the [existing] customers." 534 F.2d at 957. Under the NOPR, the Commission is proposing to allocate a pipeline's least-cost supplies among existing customers based, in effect, on the duration of the customer's relationship with the pipeline.

Also to be distinguished are the recent cases involving emergency purchases wherein the Commission (as affirmed by the courts) has departed from rolled-in pricing and has instead incrementally-charged those specific customers for whom the emergency supplies were purchased. *See, e.g.*, United Gas Pipeline Co. v. FERC, 649 F.2d 1110, *reh'g denied*, 664 F.2d 289 (5th Cir. 1981). Such cases simply hold that where the "integrated-system" and general "system-wide benefits" notions underlying the rolled-in pricing principle are absent, a departure therefrom may be appropriate.

pipeline is appropriate in recognition of the higher costs associated with newer supplies. These critics of rolled-in pricing have argued that such method unfairly burdens older customers in favor of those who had more recently attached to the system. Battle Creek, 281 F.2d at 46; see also Columbia LNG Corp. v. F.P.C., 491 F.2d 651, 654 (5th Cir. 1974). By and large, these arguments have been rejected on grounds that incremental pricing cannot properly be applied to integrated pipeline systems wherein gas supplies acquired at various locations and at various times benefit all the pipeline's customers.[19] Indeed, as recently as last year, the Commission rejected a proposed settlement package which, according to the Commission Staff, contained a "discriminatory proposal for present and future allocation of low-cost company-owned gas supplies limited to existing on-system customers." Williston Basin Interstate Pipeline Company, 28 FERC ¶ 63,020 (certification of settlement); 29 FERC ¶ 61,204 (1984) (order rejecting settlement). And, even more recently, the Commission ordered continuation of rolled-in pricing on Texas Eastern's system, in spite of arguments raised by certain parties that the company's gas costs should be segregated to more accurately reflect assignment of gas costs based on the specific supplies purchased by the individual customers. Texas Eastern Transmission Corporation, 30 FERC ¶ 61,264 (1985).

19/ See Northwest Pipeline Corporation, 23 FERC ¶ 63,079 (1983), aff'd with respect to rolled-in pricing, 27 FERC ¶ 61,012 (1984).

Having wholly failed to demonstrate a rational basis for the preferential rate treatment (in terms of gas costs) accorded to a pipeline's older customers, the Commission's proposed entitlement provision is unjust, unreasonable and unduly discriminatory in contravention of Sections 4 and 5 of the Natural Gas Act.[20]

III. The Proposed Three-Block Pricing Scheme Represents A "Taking" Forbidden By The Fifth Amendment

The three-block pricing scheme contained in the NOPR represents an uncompensated "taking" prohibited by the Fifth Amendment of the Constitution of the United States, and is thus invalid. Pipelines have entered into gas purchase contracts representing billions of dollars of obligations, to enable them to meet their Commission-certificated service obligations. These contracts collectively represent something of value to a pipeline -- the more gas a pipeline has under contract, the more sales a pipeline can make. Existing contracts require payment of prices at substantially below, and in excess of, market-clearing levels on a contract by contract basis. Payment of prices above and below market clearing levels was mandated over the last twenty-five years by the Commission's use of vintaging in establishing area and national rates for natural gas purchases,[21] and Congressional ratification of this vintaging policy coupled with implementation of gradual deregulation by the NGPA.[22] The Commission in the NOPR now wants to deprive pipelines of the opportunity to roll-in the cost of old and new supplies. Such action will substantially reduce the value to pipelines

---

[20] A different form of discrimination may result based upon different terms and conditions between the traditional 'grandfathered' Section 7 arrangements and the blanket programs. Discrimination between sales customers based solely on chronology, discussed *supra*, is equally applicable to discrimination between transportation customers. Finally, granting 'equal access' to a pipeline's system through new transportation programs may not remedy discrimination, but rather spawn it. As discussed in Part IV, *supra*, equal access to the distributor level simply shifts the site of market disorder one level further, to the distribution sector.

21/ Continental Oil Co. v. FPC (Permian Basin Area Rate Cases), 390 U.S. 747 (1968), *reh'g denied*, Bass v. FPC, 392 U.S. 917 (1968). *See also* Opinion Nos. 662 and 662-A, 50 F.P.C. 390 (1973); Opinion Nos. 546 and 546-A, 40 F.P.C. 530 and 41 F.P.C. 301, respectively (1968), *aff'd*, Southern Louisiana Area Rate Cases, 428 F.2d 407 (5th Cir.), *aff'd on reh.*, 444 F.2d 125 (5th Cir. 1970), *cert. denied*, 400 U.S. 950 (1970); Opinion Nos. 598 and 598-A, 46 F.P.C. 86 and 633, respectively (1971), *aff'd*, Placid Oil Co. v. F.P.C., 417 U.S. 283 (1974); Opinions Nos. 595 and 595-A, 45 F.P.C. 684 and 46 F.P.C. 827, respectively (1971), *rev'd and remanded*, Public Service Commission v. FPC, 487 F.2d 1043 (1973), *vacated and remanded sub nom.* Shell Oil Co. v. Public Service Commission, 417 U.S. 964 (1974); Opinion No. 586, 44 F.P.C. 761 (1970), *aff'd*, Hugoton-Anadarko Area Rate Case, 466 F.2d 974 (9th Cir. 1972); Opinion Nos. 607 and 607-A, 46 F.P.C. 900 and 47 F.P.C. 99, respectively (1971), *aff'd*, Other Southwest Area Rate Case, 484 F.2d 469 (5th Cir. 1973), *cert. denied*, 417 U.S. 973, (1974); Order Nos. 411, 411-A, and 411-B, 44 F.P.C. 1112, 1334 and 1487, respectively (1970); Just and Reasonable National Rates For Sales of Natural Gas From Wells Commenced On Or After January 1, 1973, and New Dedications of Natural Gas To Interstate Commerce On Or After January 1, 1973, Opinion No. 699, 51 F.P.C. 2212 (1974); Just and Reasonable National Rates For Sales of Natural Gas From Wells Commenced Prior to January 1, 1973, Opinion No. 749 (54 F.P.C. 3090) (1976).

22/ *See, e.g.* 15 U.S.C.A. § 3314 (NGPA Section 104, continuing the NGA just and reasonable rate with adjustment for inflation); 15 U.S.C.A. §§ 3313, 3312, 3317 (c)(5) (NGPA Sections 103, 102 and 107, respectively, providing incentive prices) (1978).

associated with the right to purchase gas under existing higher-cost contracts by rendering such gas unmarketable on a stand alone basis. In fact, the NOPR acknowledges that pipelines will be left with substantial supplies of previously-marketable gas which may be no longer marketable when separately priced.[23] Thus, Commission action has taken from pipelines the value of existing higher cost contracts. Value exists under rolled-in pricing, but value does not exist under tiered pricing.

A "taking" can occur without actual physical condemnation.[24] Indeed, the Fifth Amendment protects the right to use and dispose of property.[25] Moreover, regulation which so frustrates distinct investment-backed expectations can constitute a "taking."[26] Implementation of the three-block rate scheme repudiates the Commission's previous "usual" rolled-in pricing approach.[27] In this instance, the difference between the value of new gas under traditional pricing modes, and under the NOPR's three-block scheme, represents the diminished value of deregulated gas which has been the subject of a "taking." Thus, the Commission's proposed three-block pricing approach effectively threatens to make some gas entirely valueless, and this result represents a "taking" within the meaning of the Fifth Amendment.

---

[23] *See* NOPR, mimeo at 44, 45.

[24] *See*, *e.g.*, Kaiser Aetna v. United States, 444 U.S. 164, 178-80 (1979) (navigational servitude allowing public right of access); United States v. Causby, 328 U.S. 256, 261-62 (1946) (frequent low altitude flights of government aircraft).

[25] United States v. General Motors Corp., 323 U.S. 373, 377-78 (1945).

[26] *See*, *e.g.*, Pennsylvania Coal Co. v. Mahon, 260 U.S. 393 (1922).

[27] *See*, *e.g.*, Kansas-Nebraska Natural Gas Company, 25 F.P.C. 448, 454 (1961).

IV. Allowing a Different, and Less Competitive, Segment of the Gas Industry to Roll-In Gas Costs Will Not Solve Market Disorders

The NOPR justifies the three-block pricing method as a step to level the "playing-field" among potential competitors by diminishing the alleged "advantage" some competitors enjoy because of their cushion of low-priced gas.[28] The Commission emphasizes that competitive advantage should only be achieved through operational efficiency, not by access to old regulated gas.[29] The Commission claims that its proposal will "minimize distortions associated with the unequal availability of the old gas price cushion".[30] The NOPR, however, does not eliminate this advantage; instead, the advantage is conferred upon a different level of the industry, and any present market disorders are magnified. Therefore, the NOPR is not rationally related to its purported goals and must be modified.

---

[28] See NOPR, mimeo at 42, 50.

[29] Id.

[30] Id. at 50.

Under the NOPR's scheme, the ability to roll-in costs of regulated and deregulated gas is shifted from pipelines to distributors. The NOPR states that numerous benefits will flow from a requirement that pipelines no longer roll-in gas costs, but does not indicate how these benefits can occur if another level of the industry -- namely the distribution level -- retains the ability to roll-in gas costs. The distorting effects ascribed to pipeline rolled-in pricing will only grow with distributor rolled-in pricing. Signals to producers will still be sent by purchasers who can mask the incremental supply's true cost; signals to consumers will still be obscured by a composite cost in the ultimate consumer's bills.31/ Thus the purported market-ordering goals may not occur as a result of the proposed alteration.

In addition to failing to remedy the most serious market disorders identified in the NOPR, the Commission's proposals will concentrate more economic power in the most monopolistic sector of the industry. Eighty-four percent of pipeline sales are either to distributors with access to another source of supply or to other pipelines, as indicated by the comments of the A.G.A.

31/ State commissions may have numerous ratemaking conventions for establishing rates; many may retain rolled-in pricing. Thus the ultimate consumer will not get any more direct signal than before.

-- thus introducing market pressures of gas-on-gas competition.[32] However, distributors rarely compete with one another, and the Commission has historically protected distributors from competition by the pipelines. Thus, the NOPR will not only fail to remedy market disorders, but will place even greater economic power in the hands of the most monopolistic segment of the industry.

The Commission neglected to consider the anti-competitive aspects of the NOPR as described above. It is clear that antitrust concepts are "intimately involved" in Commission determinations, and "therefore the Commission is obligated to weigh antitrust policy."[33] The Commission must address the serious anticompetitive side-effects of its proposals, and explain why concentrating the competitive advantage of the old gas price cushion in the least competitive segment of the industry is consistent with antitrust policy and the public interest.

V. The Proposed Rules Rely on Competitive Market Forces to Set Pipeline Rates Contrary to the Requirements of the Natural Gas Act

The scheme projected in the proposed rules is based upon and directed toward the Commission belief that competitive market forces should determine natural gas rates. The NOPR is teeming with references to the goal of allowing market forces to determine rates because the Commission believes that in many areas "competition will better protect the public interest than will traditional public utility regulatory rules." NOPR at 4.

---

[32] *See* A.G.A. NOI Phase II Comments, at Attachment D.

[33] Northern Natural Gas Co. v. FPC, 399 F.2d 953, 958, (D.C. Cir. 1968). *See* FPC v. Conway Corp., 426 U.S. 271 (1976); Gulf States Utilities Co. v. FPC, 411 U.S. 747 (1973); Sebring Utilities Commission v. FERC, 591 F.2d 1003, 1015 (1979); Public Service Company of New Mexico, 25 FERC ¶ 61,469 (1983).

In fact, the proposed rules, to the extent that they rely on market forces to determine the prices many pipeline customers will pay for gas, represent an abdication by the Commission of its duty under Sections 4 and 5 of the Natural Gas Act to protect consumers from unjust and unreasonable rates. "[W]hat is 'just and reasonable' is not determined by the pressures of competition but by the adequacy of the service to the public, the fairness of the return . . ., and the degree to which the Congressional objective of efficient use of the nation's power resources is served." *Pennsylvania Water & Power Company v. FPC*, 193 F.2d 230, 234 (D.C. Cir. 1951), *aff'd*, 343 U.S. 414 (1952). *See also* *FPC v. Texaco, Inc.*, 417 U.S. 380, 397-99 (1974); *Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1508-10 (D.C. Cir. 1984).

Moreover, when relying upon a non-cost factor, such as competition, in setting rates, the Commission must explain why resulting rates are just and reasonable. *See* *Farmers Union*, *supra*, 734 F.2d at 1502. This the Commission has not done. Indeed, it cannot since it does know what competition and market pressures will do to rates in the future. *See*, *e.g.*, *State of North Carolina v. FERC*, 584 F.2d 1003 (D.C. Cir. 1978). Furthermore, it is not enough for the Commission to compensate pipelines -- in the form of a higher rate of return -- for the additional risks which it seeks to impose through reliance on competitive forces; the Commission is duty-bound to permit pipelines a "reasonable opportunity" to earn its stated rate, and providing a higher return rate, if unobtainable, cannot satisfy this obligation. See F.P.C. v. Hope Natural Gas Co., 320 U.S. 591 (1944). Finally, had Congress desired that competition set rates, the legislative branch would only have had to remove that activity from Commission jurisdiction, but Congress did not do so. Yet the Commission's action effectively removes substantial portions of the market from its oversight, contrary to Congressional intent.

Therefore, the pricing schemes proposed by the Commission violate Section 4 of the Natural Gas Act and also Congressional intent as embodied in the pricing provisions of the Natural Gas Policy Act of 1978.

VI. The Commission Cannot Directly or Indirectly Regulate Pipeline Rates to Direct Sale Customers

The Block I "entitlements" feature of the NOPR mandates prorata allocation of lower cost gas to all pipeline firm customers, including firm direct customers. The NOPR also requires that El Paso's new sales -- jurisdictional and non-jurisdictional -- be made solely from Block II gas.

These features of the three tier billing proposal demonstrate that the Commission is attempting to regulate pipeline direct sales rates. As explained below, any attempt to regulate direct sale rates is an unlawful attempt to enlarge the Commission's statutory authority, and may not, therefore, be implemented. Fuels Research Council v. F.P.C., 374 F.2d 842 (3d Cir. 1967).

Although El Paso agrees that firm direct sale customers should be entitled to an allocable portion of Block I volumes, the price charged for such volumes is subject only to the contract between the parties. The Natural Gas Act, and the cases decided thereunder are clear: the Commission is without authority to regulate, either directly or indirectly, the rates charged by an interstate pipeline to a direct sale customer.[34] Accordingly, the proposed attempt (through the block-pricing scheme) to regulate the rates charged for gas sold to direct sale customers -- whether such volumes represent the direct sale customer's Block I entitlement, or derive from Block II -- are outside the Commission's rate-setting authority under Sections 4 and 5 of the Natural Gas Act, and beyond the jurisdictional reach of Section 1(b) of the NGA.

---

[34] Federal Power Commission v. Louisiana Power & Light Co., 406 U.S. 621 (1972); see also Florida Gas Transmission Company, Opinion No. 14-A, 24 FERC ¶ 61,005 at 61,033 (1983) where the Commission observed:

> The Commission, however, cannot set rates for FGT's [direct] sales to Florida Cities in order to insure that Florida Cities pay rates which recover only the costs allocated to these services. The rates are subject to state and local authority and to the contracts between FGT and Florida Cities . . . . For these same reasons, we conclude that the Commission lacks authority to condition the authorizations granted here in order to accomplish indirectly what we cannot do directly. [Citation omitted].

Senator Nickles. Mr. Morris, thank you very much.

Mr. Ramsey, with Tennessee Gas Pipeline.

STATEMENT OF JOSEPH E. RAMSEY, VICE PRESIDENT, MARKETING, TENNESSEE GAS TRANSMISSION CO.

Mr. Ramsey. Thank you, Mr. Chairman, Senator Bingaman.

My name is Joe Ramsey. I am vice president of marketing for Tennessee Gas Transmission Co., the interstate pipeline subsidiary of Teneco Inc. As pointed out in our written statement, Tennessee Gas is one of the largest pipeline companies in the United States in both sales and transportation. In 1984 we tranported over 700 billion cubic feet of gas for others, other pipeline companies, our sales customers, producers, brokers, as well as end users.

Our written statement contains answers to the four specific questions asked of those appearing today. I would like to skip questions 1 and 2 and use my short time to address 3 and 4.

Question 3 asked whether the proposed rulemaking would create a regulatory system that would assure residential, commercial and industrial consumers a reliable long-term supply of natural gas at the lowest possible cost. Our answer to that question, based on 42 years of experience in this business, is a very definite no. Reliable long-term service, lowest reasonable cost has been developed in this industry through long-term contractual obligations which would become a thing of the past under this proposed rulemaking.

We admittedly have serious problems in this industry today because the same long-term, rigid contractual obligations of yesterday cannot respond quickly enough to today's environment of rising supply, shrinking demand, and declining spot or marginal supply prices. Clearly the answer to these rigidities is renegotiation of problem contracts wherever they exist in the system. But where is the carrot or the stick to cause that renegotiation—not in the NOPR.

Producers are understandably reluctant to surrender valuable contract rights bargained for at arm's length, even though the environment in which those bargains were struck is no longer operative. Similarly, some pipelines have been understandably reluctant to transport gas that supplants their system sales and aggravates their already large take-or-pay obligations.

Tennessee and other interstate pipelines have been telling the FERC since 1983 that take-or-pay obligations are the principal problem of the natural gas industry and that take-or-pay obligations are the principal obstacle to a more open and competitive gas transportation network. But the FERC has consistently refused to face up to the take-or-pay problem; instead, it has promulgated rules which have only made it worse.

Order 380, issued in mid-1984, removed gas cost obligations from pipeline minimum bills for its customers, aggravating the take-or-pay problem. The special marketing programs, or SMP's, allowed many end users to leave the traditional purchase system and buy spot gas, aggravating the take-or-pay problem. Extending the SMP eligibility to 10 percent of pipelines' core markets allowed further purchase reductions, with attendant take-or-pay increases.

All of these FERC actions have increased the customers, ability to not buy pipeline gas, with not one effort to cure the resulting pipeline producer take-or-pay problems that these actions exacerbated.

These recent actions by FERC can best be characterized as follows. The FERC can and will and has capriciously and cavalierly changed the rights and obligations of gas customers and the supplying pipelines; however, as to the rights and obligations between pipelines and their producers they take the tack that a contract is a contract.

Now let me stop here and apologize if I'm sounding too shrill or too partisan for my industry. I don't mean to be, and Tennessee's comments to the FERC on NOPR are, I think, the most positive and constructive of any of the interstate pipelines. We want to make this industry work properly, if we can, and personally we don't care whether we buy and sell gas or whether we act as a transporter. We just need some help in getting from here to there.

Our comments to the FERC—and I have copies available if anyone would like one—suggested a scheme whereby transportation access under the NOPR and access to expedited certificates by pipelines would be contingent upon contract renegotiation. There were restrictions in there on both the pipeline and the producer to try to force this renegotiation. The details of our suggestions are also in the written statements furnished to the subcommittee.

Let me turn now to question 4, the effect of NOPR upon supply availability and exploration incentives. The FERC has claimed that block billing and carving out the older, cheaper gas will level the playing field for all pipelines. No one will have a cheap gas advantage. However, it would clearly tilt the playing field for producers. Those with old cheaper gas, some of which is not so cheap any more, will see high production; those with block 2 gas will see little, if any, takes.

Again, the FERC seems to be saying the old gas belongs to the customers. We're going to give that to them, but the new higher cost gas, well, that's for the pipelines and the producers to work out. In all likelihood, production incentives and cash generated from gas production under this scheme will be insufficient to generate the discovery and connection of gas supplies adequate to meet the long-term demand in this country. At some point, no doubt, several years in the future shortages will occur.

Market dislocation and supply reliability problems can best be dealt with by legislation amending the NGPA. Such legislation, in order to deal effectively with current problems, would deregulate the price of all gas at the wellhead and couple such deregulation with a statutory requirement that all first sale contracts for natural gas would have to be renegotiated within a limited period of time or be subject to termination at the option of either party. That would force all pipelines to negotiate low price contracts upward and producers to renegotiate high-price contracts downward.

In the absence of such legislation the FERC should administratively require contract renegotiation as a quid pro quo for transportation access or expedited certificate access, as discussed previously. Thank you.

[The prepared statement of Mr. Ramsey follows:]

WRITTEN STATEMENT OF
TENNESSEE GAS TRANSMISSION COMPANY
TO THE SENATE SUBCOMMITTEE ON
ENERGY REGULATION AND CONSERVATION
OVERSIGHT HEARING ON SEPTEMBER 19, 1985

Mr. Chairman and Members of the Subcommittee:

My name is Joseph E. Ramsey, and I am Vice President for Marketing of Tennessee Gas Transmission Company. Tennessee appreciates very much this opportunity to present its views to the Subcommittee on the Notice of Proposed Rulemaking titled "Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Docket RM85-1-000" (NOPR) issued by the Federal Energy Regulatory Commission (FERC) on May 30, 1985.

Tennessee Gas Transmission Company is the interstate pipeline division of Tenneco Inc. Tennessee operates three interstate pipeline systems, Tennessee Gas Pipeline Company, Midwestern Gas Transmission Company and East Tennessee Natural Gas Company. Tennessee's interstate natural gas pipeline systems serve markets in twenty-six (26) states, and indirectly serve approximately eighteen (18) million gas consumers. Tennessee's pipelines serve major metropolitan markets including Chicago, New York City and the New England area, but also serve numerous small local distribution companies, many of which are municipally owned and operated. On a volumetric basis, ninety-seven percent (97%) of Tennessee's markets are competitive, in that they are served by other interstate pipeline systems as well as Tennessee.

Tennessee has been an industry leader in trying to cope with the severe imbalance between supplies of natural gas and demand for natural gas that has existed in this country since early 1983 and with the rapidly changing natural gas markets. Examples of this are:

(1) As the imbalance between supply and demand grew to significant proportions, Tennessee implemented an Emergency Gas Purchase Policy in May, 1983, in an effort to reduce the price of its system supply to and the adverse impact of take-or-pay on its customers while sharing its market equitably with all of its producer/suppliers. The Emergency Gas Purchase Policy requires Tennessee to take ratably from all producers as to each vintage in pricing category of natural gas. The policy also provides for the payment of take-or-pay at reduced levels. As a result of the implementation of the Emergency Gas Purchase Policy, Tennessee reduced its prices to its customers by approximately $0.41 per MMBtu, and increased its wellhead purchases and sales of gas from a projected 826 Bcf in 1983 to 864 Bcf, and achieved sales levels of 968 Bcf in 1984.

(2) Tennessee has been active in transporting gas for others. To illustrate, in 1982 TGP moved 624 Bcf of gas for third parties; in 1983 it moved 578 Bcf; and in 1984 it moved 752.5 Bcf, among the highest transportation levels in the interstate pipeline industry.

With the foregoing as background, let me now take up the four matters set out in the Subcommittee's September 9th invitation to appear at this oversight hearing.

(1) Would the public interest be better served by retaining the existing regulatory system? Tennessee believes the answer to this question is clearly yes. The problems of the natural gas industry are the result of the failure of the FERC to use the broad and flexible jurisdiction and authority the system reposes in it to address and resolve the transition of the industry from shortage to surplus. As Tennessee's comments to the FERC in response to the NOPR and to its notices of inquiry that preceded the NOPR reflect, Tennessee believes that the existing regulatory scheme provides ample flexibility and authority to deal with the current gas market situation. Indeed, flexible application of traditional rate design principles on a pipeline by pipeline basis holds the most promise of giving gas consumers reliable gas service at the lowest reasonable price, and providing the economic incedntives necessary to induce voluntary, non-discriminatory transportation of gas.

Pipeline systems are not homogenous in the manner in which they are constructed, in the manner in which they operate, in the manner in which they acquire supply or in the markets they serve. Some pipelines, like Tennessee, buy most of their supply at the wellhead, while others buy gas supplies both at the wellhead and from other pipelines, in varying proportions. Some pipelines serve more competitive markets than others, and some pipelines' markets are currently better than others. Pipelines have been designed and constructed pursuant to specific certificates of public convenience and necessity, and their facilities can thus operate at varying levels in varying locales. The Commission has ample authority under the Natural Gas Act (NGA) to take all of these matters into consideration in designing rates which provide a balance of incentives to pipelines to transport gas for others as well as to market their own supplies of gas. No generic rule can produce an equitable result on all pipeline systems and in all markets.

Clearly, expansion and simplification of the various self-implementing transportation rules and blanket certificate programs now in existence is indicated, and in fact has been sponsored by pipelines and producers alike. Nonetheless, the current regulatory system is designed to provide supply reliability at reasonable cost, and can be made to do this without major modification. The FERC can only accomplish this, however, if it broadly and flexibly exercises the powers granted to it pursuant to the NGA and the Natural Gas Policy Act

(NGPA), something the FERC has been surprisingly reluctant to do. For instance, in the period following the enactment of the NGPA the FERC actively asserted its authority to regulate the purchasing practices of natural gas pipelines to fill what was perceived by many to be a void in its ability to control the cost of natural gas supplies to the consumers. When the price of natural gas to interstate pipelines began to be adversely impacted by the existence of take-or-pay provisions, which provisions were themselves a product of the pervasive regulation of the pipelines, the Commission not only refused to acknowledge the problem or to deal with it, but began to back away from its earlier profession of authority to regulate pipeline purchasing practices. The void created by this reluctance to exercise regulatory power in an appropriate way is the principal cause of market dislocation for all segments of the industry, pipelines, producers and local distribution companies alike.

(2) Would the NOPR create a regulatory system that would be operationally workable and legally sound? Tennessee believes that in the main this question must be answered negatively. Tennessee respectfully invites the Subcommittee's attention to its comments filed in response to the NOPR, copies of which I have available today, as well as the comments of the American Gas Association, the Interstate Natural Gas Association of America, and many others, reflecting the practical and legal problems with the majority of the initiatives the Commission proposes to take pursuant to the NOPR.

(3) Would the NOPR create a regulatory system that would assure residential, commercial and industrial customers a reliable long term supply of natural gas at the lowest possible cost? Again, Tennessee is constrained to answer in the negative.

Tennessee and other interstate pipelines have been telling the FERC since 1983 that take-or-pay contracts are the principal problem of the natural gas industry, and that take-or-pay obligations are the principal obstacle to a more open and competitive gas transportation network. The FERC has yet to face squarely the take-or-pay problem. In fact, the FERC in mid-1984 issued Order 380 eliminating all gas costs from minimum bill provisions in the service contracts between pipelines and their customers. The FERC has consistently refused to address the effect this major regulatory abrogation will have on pipelines' ability to meet their take-or-pay obligations to producers. The FERC continues to assume, with no proof, that it can ignore the take-or-pay problem and it will go away through contract renegotiations. Contract renegotiations have occurred, and take-or-pay relief has been granted by producers to pipelines, but most of such relief has been short term in duration and deals with current take-or-pay accruals. Such interim agreements do not address the long term problem that results from the fact that as long as surplus deliverability overhangs the market, take-or-pay obligations build up every year, with less and less likelihood that such obligations can be worked off by delivery of makeup supplies of gas. Producers are understandably reluctant to surrender valuable contract rights bargained for at arm's length, even though the environment in which those bargains were struck is no longer operative. Pipelines are understandably reluctant to transport gas that supplants their system supply sales and aggravates their already large take-or-pay obligations.

Tennessee proposed, in its comments on the NOPR, that the FERC use its authority under Section 7 of the NGA to condition access to transportation on contract renegotiation. Such an approach, which could be effected by the FERC as part of a streamlining and simplification of existing self-implementing and blanket transportation programs, would provide an equitable balance of incentives to resolve the take-or-pay contracts problem that now confounds the industry. More specifically, Tennessee proposed:

A. As a condition to the blanket transportation certificate and self-implementing transportation authorizations, the optional expedited certification procedures, and the presumption of justness and reasonableness on Block 2 rates, a transporting pipeline should be required:

    1. To make a good faith effort to renegotiate its Block 2 gas purchase contracts to include market sensitive pricing provisions and to deal with take-or-pay problems; and

2. To offer to release to the producers the reserves under any Block 2 contract that has not been renegotiated by December 31, 1986, and to transport the released reserves from the producer to another buyer.

B. To be eligible to receive transportation service under a blanket transportation certificate or self-implementing transportation authorizations, a producer should be required:

1. To make a good faith effort to renegotiate its Block 2 contracts with the transporting pipeline to include market sensitive pricing provisions and to deal with take-or-pay problems; and

2. To accept a release of the reserves under those Block 2 contracts that have not been renegotiated by December 31, 1986, and to refund any take-or-pay received and to waive all take-or-pay liabilities accrued under those contracts.

C. To encourage the voluntary renegotiation or release of all Block 2 contracts, the Commission should order all pipelines providing nondiscriminatory transportation services not to pay any claims for take-or-pay maturing after the effective date

> of the final order in this docket, arising under the provisions of any gas purchase contract with any producer that has not been renegotiated as of December 31, 1986.
>
> Pregranted abandonment should be issued for all Section 102(d) reserves released under these procedures. Once transportation service is commenced, the pipeline should not be allowed to terminate transportation to a producer on the grounds of failure to negotiate in good faith prior to December 31, 1986, without prior approval of the Commission.

(4) What impact would the regulatory system the NOPR proposes to create have on exploration for new gas supplies, and production from existing gas reserves? The proposed block billing scheme will result in the shutting in of most higher priced new supplies of gas, and the production at extremely high levels of the older, lowest priced gas. To the extent that the older gas is price capped at levels below reasonable cost of deliverability and reserves maintenance operations, these older fields will be exhausted and will not be replenished. In all likelihood, production incentives and cash generated from gas production will be insufficient to generate the discovery and connection of gas supplies adequate to meet the long term gas demand in the country. At some point, no doubt several years in the future, shortages will occur.

Market dislocation and supply reliability problems could be better dealt with by legislation amending the NGPA. Such legislation, in order to deal effectively with current problems, would have to deregulate the price of all gas at the wellhead, and couple such deregulation with the statutory requirement that all first sale contracts for natural gas would have to be renegotiated within a limited period of time or be subject to termination at the option of either party.

Absent such legislation, the FERC should administratively require contract renegotiation as a quid pro quo for transportation access as discussed previously. The advantages of requiring all contracts to be renegotiated would be at least the following:

1. All gas would be priced at the market price all over the country. Price signals would be more meaningful.

2. The transition time to a free market would be radically reduced as compared to using the block pricing methodology.

3. With gas in surplus and spot prices at low levels, now is the ideal time to move to market pricing.

4. Market pricing would eliminate regional disparities in gas prices arising out of regulation. There would be no discrimination among consumers as will exist with block pricing.

5. Market pricing would eliminate the need for block or vintage controls and would greatly aid in achieving ratable takes among producers.

6. It would assure maximum recovery of gas from all reservoirs, without regard to pricing block.

Finally, required contract renegotiation will force resolution of the take-or-pay problems between producers and pipelines, the major stumbling block to a more efficient system.

Thank you again for the opportunity to discuss these matters with you. I will be happy to answer any questions the Subcommittee may have.

Senator NICKLES. Mr. Ramsey, thank you very much.
Mr. Dienstbier.

STATEMENT OF DAN DIENSTBIER, EXECUTIVE VICE PRESIDENT FOR GAS PIPELINE OPERATION, HNG/INTERNORTH

Mr. DIENSTBIER. Thank you. My name is Dan Dienstbier. I am executive vice president responsible for the gas pipeline activities of HNG/Internorth. In addition to natural gas pipeline activities, of course, HNG/Internorth is a significant independent producer.

I certainly appreciate the opportunity to be here with you today. HNG/Internorth has filed substantial written comments, both with the FERC in the proposed rulemaking and with this committee. Therefore, in the interest of time I will simply confine my comments to the specific questions raised by the committee.

The first question asked was whether the public interest would be better served by retaining the assistance of the regulatory system. I'll admit it's tempting sometimes to consider retreating to familiar ground of traditional regulation. We believe that is not, however, realistic. We do not believe that that is even feasible, for two reasons.

First, the marketplace in fact does demand a different set of prices and a different set of service options than traditional regulation permitted. Furthermore, a court has determined that at least a portion of what has become to be traditional regulation in the form of special market programs are unduly discriminatory. The only choice, we believe, in the final analysis, is whether the FERC attempts to change the regulatory network and system or if the task is going to be left to Congress.

The second question was concerned with the operational workability and the legal soundness of the Commission's proposed rule. We believe, of course, that any regulatory system or any system can in fact be made workable. The question, of course, is whether that system is in fact efficient. The proposed rule, in our opinion—and I know this is shared by many, many others who have commented on it—relies far too much on the standardized formulas and solutions and far too little on negotiations to be efficient.

If FERC adopts many of the suggestions that we have made, and others—pipelines, producers, and consumers—we believe that the workability of the proposal can in fact be assured.

On the issue of legal soundness, I think there's been enough said here today on the first panel and on this one. I think it's absolutely clear that any proposal as broad and that has as much impact on as many segments of the industry will in fact be challenged in the courthouse.

Third, the committee asked whether the notice of proposed rulemaking creates a regulatory system that can ensure consumers a reliable and long-term supply of natural gas at the lowest possible cost. In our view, with the decontrol of wellhead prices, or at least substantial decontrol, as mandated by the Natural Gas Policy Act, it seems to us that the issue of price and cost really ceases to be as great an issue of regulatory concern as it has been in the past.

Market forces are in fact being relied upon to determine the appropriate natural gas price level. The NOPR, we believe, can, as it's proposed, contribute to an efficient market or at least a more efficient market by setting up a regulatory scheme or schedule which better permits the price signals to be transmitted between producers and consumers.

Furthermore, we believe the NOPR establishes a regulatory scheme under which consumers at all levels can take a great deal more responsibility for the reliability of their gas supply than has been the case in the past under the old rules.

To the extent that the competitive forces which were unleashed by decontrol of wellhead prices through the NGPA are allowed to work through the basic structure, as outlined by NOPR, we believe that the consumer will in fact be well served, whether he is residential, commercial, or an industrial end user.

Now although we believe that competition will provide a high degree of confidence in both price and supply, it should be expected that errors will be made under the NOPR. With the thousands of decisions—and these are individual decisions—regarding price and supply made both by buyers and sellers, there will be mistakes, particularly in the transition period. Although we expect some mistakes, we believe that it is inappropriate to condemn what in fact can be a freer, more responsive system merely because we expect a minority of mistakes or errors to be made.

I think it's important to understand that the present regulatory scheme we have has not been totally successful in providing either long-term supply assurance or the lowest possible price either.

The last area of concern expressed by the committee was the effect that the NOPR would have on the exploration for new gas supplies and production from existing reserves. We believe that if the regulatory scheme established by the NOPR, with modifications that have been offered by many people, could create an environment in which exploration for new supplies of gas will in fact more closely match the market demand for gas, in the longer run we believe that it would be far easier for a producer to evaluate real market demands and to determine the appropriate level of risk and investment he really wants to make.

We believe that allowing price to be the moderating force will reduce the wide swings in supplies that have characterized this industry for the last many, many years. In the shorter run, without question the NOPR holds a potential for reducing the marketability of the higher-priced gas supply, as per the proposal on block 2.

Finally, with respect to the NOPR's impact on existing reserves, we really doubt that any generic conclusion could be made. First, production decisions, with or without the notice of proposed rulemaking, are highly company-specific. They are highly complex. They depend on numerous factors. Second, the issue of when to produce existing reserves, particularly the low-cost reserves, is a matter of what goals a purchaser or a producer wants to achieve over what time period.

I thank the committee very much for giving us the opportunity to be here with you today.

[The prepared statement of Mr. Dienstbier follows:]

Remarks of Dan Dienstbier
Executive Vice President, HNG/InterNorth
before the U.S. Senate Subcommittee on
Energy Regulation and Conservation
September 19, 1985

I'm Dan Dienstbier, executive vice president of gas pipeline operations, HNG/InterNorth. HNG/InterNorth operates an extensive network of pipelines in both interstate and intrastate commerce. I am pleased to appear before this distinguished Senate panel to give you our views on the Notice of Proposed Rulemaking recently issued by the Federal Energy Regulatory Commission.

The HNG/InterNorth companies have long urged substantive change in the regulation of natural gas pipelines--changes which would remove many of the time-consuming, inflexible regulations on the purchase, transportation and sale of natural gas. We have urged these changes because we believe that the market is now demanding a broader range of price and service options than allowed by current regulation. In California, for example, we have been aggressive in competing for existing markets by providing transportation of spot gas and in competing for new markets by proposing to build a new pipeline offering transportation services to the enhanced oil recovery market. In both instances, the type of service demanded by the customer is now different from the traditional sale-for-resale mode that gas pipelines have operated in for so long.

HNG/InterNorth applauds the efforts of the FERC to encourage competition and to provide a regulatory framework for more market-responsive behavior on the part of all industry participants. Our companies have participated heavily in the proceedings of the Commission throughout 1985, including responses to the Notice of Inquiry, testimony at hearings, responses to the Notice of Proposed Rulemaking, as well as frequent discussion of the issues among state regulators, distributors, producers and other pipeline companies.

Before I answer the committee's specific questions, I would like to present our broad view of the NOPR. In our view, four concepts embodied in the NOPR are especially critical to a successful restructuring of the industry:

1. Allowing more open competition for sales and transportation markets.
2. Allowing negotiation of transportation services and contract modifications.
3. Removing the effects of the "old gas cushion" in competing for new markets.
4. Reducing the regulatory burdens associated with constructing new pipelines.

The major conceptual failures of the NOPR are the constraints the Commission places on negotiation among the parties on such issues as transportation rates, modification of contracts, and allocation of old gas. By constraining market-based solutions to these difficult issues, the Commission impedes, rather than assists the functioning of the market. Further, where the regulatory framework already provides for considerable negotiation among the parties (e.g., in the intrastate market), the Commission should not seek to impose new regulatory impediments to the functioning of the market. Let me address each major issue in turn.

First, while the NOPR clearly contemplates more negotiation on transportation tariffs than currently provided, the Commission's proposals expose the pipeline to more downside risk but limit the upside reward. Specifically, the ceiling price for transportation rates should be increased to reflect greater risks of the new regulatory environment. In addition, where a new facility is being built, the Commission should not limit the expedited certificate procedure to projects which use only Commission-prescribed rate concepts. Rather, the Commission should allow parties to negotiate their own risk-sharing arrangements. If the Commission wants to promote a healthy and competitive industry, it must make the rewards more commensurate with the risks.

Second, the NOPR's proposals for modifying pipeline/customer contracts and for resolving pipeline/producer take-or-pay problems rely too much on standardized regulatory requirements and too little on negotiation. Our major concern with the pipeline/distributor contract proposal is its lack of balance. Distributors are given unilateral rights to walk away from pipeline contracts. The Commission's proposal would be more fair if distributors were allowed to convert sales service to transport service, and pipelines were given more opportunity to recover their fixed cost of service. The Commission must afford the pipeline the timely opportunity to alter its cost structure in response to the changes in service resulting from the new rules of the game.

The Commission's take-or-pay proposal similarly needs a better balance. Pipelines are given one year to resolve all take-or-pay problems with producers while their customers are given rights to modify contract demand over a four-year period. In addition, just as the Natural Gas Policy Act's price "ceilings" became price floors, the Commission's standardized take-or-pay solution will become a floor for pipeline/producer negotiations. The Commission should stress incentives for renegotiation rather than prescribe the outcome of the negotiation process.

Finally, the Commission's proposed procedures for allocating the benefits of the "old gas cushion" are too restrictive and are unfair to certain customers. We agree with the Commission's goal of prohibiting the use of the old gas cushion in the competition for new markets; but, we believe that goal can be achieved in a way which is more fair to a pipeline's customers. Specifically, interruptible customers are discriminated against under the NOPR's proposed scheme because the "rights" to old gas are allocated only to firm customers. At a minimum, rights to old gas should be allocated to all historical customers. Better yet, because fact situations differ so much within the industry, individual negotiations between a pipeline and its cutomers are a better solution to the problem of allocating the old gas benefits.

Let me now turn to the committee's specific questions. We do not believe the Commission has the option of retaining the existing regulatory system. In essence, the Commission has the choice of returning to the very rigid regulatory practices of the past in which virtually no competition was permitted and flexibility in service was sharply limited, or developing a new regulatory system to accommodate a greater range of price and service competition. We believe the public interest is served by a change in regulatory direction to more competition. A great deal of market choice and flexibility would be lost if the Commission allows blanket transportation certificates to expire without replacing them with an alternative.

HNG/InterNorth shares many of the concerns evidenced by the committee in the questions posed. In terms of the NOPR's operational workability and legal soundness, we believe it is fair to say that almost any scheme can be made to work. The more appropriate question is whether the proposed rule is operationally efficient. As noted earlier in this testimony, we believe that the NOPR suffers from too great a reliance on prescription for how parties are to act and too little reliance on negotiation among the parties.

HNG/InterNorth has suggested to the Commission a number of modifications which will improve the workability and efficiency of the proposed rule. These suggestions are set out in HNG/InterNorth's comments to the FERC on the NOPR, Docket RM85-1. The executive summary of those comments is appended as Attachment A. As noted earlier, we have several concerns with the NOPR. However, we believe adoption of our suggestions would improve both the workability and legal soundness.

Regardless of any efforts to improve the legal soundness of the proposed rule, simply because of its sweeping nature and complexity, legal challenges are almost a certainty.

The committee asked whether the NOPR creates a regulatory system which assures consumers a reliable, long-term supply of natural gas at the lowest possible cost? With the decontrol of wellhead prices as mandated by the NGPA, the issue of price and cost ceases to be as great a regulatory concern as it has been in the past. Market forces are being relied on to determine the appropriate natural gas price level. Consumers are now much freer to choose among price and service options as pipelines unbundle their services.

The NOPR contributes to an efficient market by setting up a regulatory scheme which permits price signals to be transmitted between producers and consumers more quickly and with less distortion. Further, the NOPR establishes a regulatory scheme under which consumers at all levels can take a great deal more responsibility for the reliability of their supply than in the past. In some areas, even residential consumer groups are making efforts to arrange for their own supply.

To the extent that the competitive forces unleashed by the decontrol of wellhead prices are allowed to work through the regulatory scheme established by the NOPR, the consumer will be well-served whether he is a residential, commercial or industrial consumer. However, changes are needed to the NOPR to make these competitive forces fully effective.

Even though competition will provide a high degree of confidence in both price and supply, errors will be made by some. With the thousands upon thousands of decisions about price and supply which will be made by buyers and sellers, there will be mistakes made, especially in the earlier stages of the shift to the reliance on market forces rather than regulation. We must be prepared to accept the fact that among the greater majority of successes, there will be a minority of failures. As we we note those failures, it would be inappropriate to rush to condemn the freer system. We must remember the present regulatory scheme was unsuccessful in providing either long-term supply assurance or low prices during the past decade.

Another of the concerns expressed by the committee is the effect the NOPR will have on the exploration for new gas supplies and the production from existing reserves.

HNG/InterNorth believes that the regulatory scheme established by the NOPR, if the modifications we have proposed are adopted, could create an environment in which exploration for new supplies of gas will more closely match the market demand for gas. Thus, it will be far easier for a producer to evaluate market demands and determine the appropriate level of investment and risk he wants to assume. We believe such an environment is far healthier than the regulated environment of the past where prices were set by fiat. We also believe that allowing price to be the moderating force will reduce the wide swings in supply we have experienced over the past decade.

In the shorter run, the NOPR holds the potential of reducing the marketability of higher-priced gas supply. As purchasers evaluate their choices, they may well elect to purchase a greater portion of their needs on the spot market since it may provide very attractive prices. To the extent this occurs, higher-priced supplies may well become less marketable than they are today.

In closing, HNG/InterNorth believes the FERC has made a bold move forward in its development of the NOPR. While the NOPR incorporates many of the reforms the company has been advocating for several years, the proposal needs significant modifications before it can provide a suitable framework for an efficient, workable, competitive market.

The company has made extensive suggestions to the Commission throughout the development process of this new rule. We believe these reforms are in the best interest of not only our industry, but the nation's natural gas consumers as well.

I thank the committee for permitting me to share my views and those of my company with you today.

Attachment A

Attachment A

EXECUTIVE SUMMARY
of HNG-InterNorth Comments
Docket No. RM85-1 (Parts A-D)

The Commission has made a bold move toward restructuring the regulation of the natural gas industry, a move we have advocated for some time. While supporting the fundamental changes and concepts advanced by the Commission, we are concerned that those participating under the proposal must be allowed to compete on equal terms and that they be provided adequate incentives to restructure existing contractual relationships to allow a transition to more competition in all segments of the natural gas industry. We believe that our concerns can be alleviated if the Commission will consider and address the modifications to the proposal set forth in our comments which are summarized below.

PART A - TRANSPORTATION

- ° Existing sales customers should not be allowed to "walk away" from contractual obligations.
    - Unless distributors have excess contract demand, they should be required to convert contract demand reductions into reserved firm transportation capacity with an attendant obligation to pay a reservation or demand charge.
    - The pipeline must be given the opportunity to recover any demand revenue shortfall resulting from contract demand reductions.
- ° A customer's ability to reduce contract demand at any time upon 30 days' notice is unreasonable.
    - A customer should be permitted to reduce contract demand on an annual basis on a date set by the pipeline upon six months advance notice.
- ° The Commission must expand its proposal to address expedited abandonment procedures.
    - Abandonment applications should be permitted under a prior notice procedure.
- ° There is no need for requiring peak and off-peak rates.
    - Pipelines and customers should be able to negotiate market responsive rates between the minimum and maximum rates which would eliminate the need for developing such rates.
- ° The Commission must distinguish between firm and interruptible transportation to establish "curtailment" priorities.

  - The issue of curtailment, as it applies to transportation, is actually an issue of allocating capacity. Interruptible transportation must be curtailed first, regardless of end use, for purposes of allocating capacity.

- All existing transportation services, as of the date a final order in this proceeding becomes effective, should be continued under existing arrangements until the termination date of such aggreements.

  - Depending upon the decisions made by third-party transporters. disruption of service could occur if such continuity does not occur.

- Equal access provisions and rate conditions should not apply to inrastate pipelines, or at a minimum, should be clarified.

  - Equal access provisions, if applicable at all, should only apply to 311 (a)(2) transactions.

  - Currently available rate options should remain available without modification.

PART B - TAKE OR PAY

- The proposal is an inadequate solution to the take-or-pay problem.

  - The Commission's formula approach may well serve as a floor for negotiations and could thereby increase the real cost of solving the problem.

- Adequate incentives do not exist to compel a producer to enter into negotiations.

PART C - EXPEDITED CERTIFICATES

- "At risk" facilities should be segregated from and accounted for separately from a pipeline's rate base.

  - Risk associated with underutililzation should be limited to incremental facilities. If facilities are subsequently utilized for general system operations, costs should be allocated to ratepayers.

- The Commission must consider the upside for taking risks.

  - Pipelines and shippers should have discretion to negotiate rates commensurate with the service provided in order to provide both risks and rewards to the pipeline.

PART D - BILLING PROCEDURES FOR PURCHASED GAS

- Existing customers should not have exclusive rights to "old" gas simply on the basis of historical firm purchases.
  - Any customer purchasing firm sales demand should be entitled to "old" gas pricing. Whenever a customer reduces firm demand or a new customer is added, a reallocation of "old" gas must be made.
- Block 2 gas should be divided between renegotiated and non-renegotiated contracts.
  - Provides incentives to producers.
  - Eliminates a rolled-in approach that could make some Block 2 gas unmarketable.
- The proposed allocation formula unduly discriminates against existing interruptible sale-for-resale and direct sales by pipelines.

Senator NICKLES. Mr. Dienstbier, thank you very much for coming.

Senator Bingaman, do you have any questions for this panel? I do, but I don't want to hold you if you want to ask.

Senator BINGAMAN. Thank you very much, Mr. Chairman. I do have a few questions, if I could.

I guess what I'm hearing in all this testimony is that there are really two major negative impacts from what's being proposed here. No. 1, if the proposal goes into effect it would have an adverse effect on drilling and exploration and renegotiation of contracts and, second, the prospect of the litigation which will result is a major additional sort of overlay of concern.

I noticed that some of the appendixes or attachments to the testimony here look ominously like briefs that might be filed in courts of law.

Mr. Morris, you made some reference to the maelstrom of litigation that you anticipate. I gather you are talking both about litigation to challenge the rule, but also litigation between producers and pipelines and others in the industry.

Maybe you or any of the other panelists would just elaborate on the problems you see resulting from this litigation and the uncertainty during the time it's pending.

Mr. MORRIS. Senator, I think you have an accurate perception of the point. The litigation that I referred to would be litigation not only as to the validity of the NOPR but as to the effect of it upon contracts and State conservation laws.

Concerning the validity of the NOPR, I think that that is one of the aspects that throws a cloud over the viability of the industry during the period of time it takes to resolve that litigation. I would hope that that type of litigation might go quickly, but even at best it could take years to resolve.

In the meantime, no one knows what the rules of the game are. It's difficult to renegotiate problem contracts. It's difficult, if not impossible, to enter into new contracts, except that they might be conditioned upon some ultimate outcome of the NOPR, which makes it probably an illusory contract at best.

Concerning the litigation with producers, we're not anxious to get into litigation with producers, but at the same time if you have unmarketable gas—and previous witnesses have addressed this point very clearly—if you have unmarketable gas then the basic argument would be that the effect of the NOPR operates in such a way as to create conditions of force majeure under the contracts themselves that would in effect impose the right to lower the price to a market-clearing level.

I certainly don't expect all the producers to agree with that assertion. So you'd have extensive litigation over that as well.

Senator BINGAMAN. Anybody else want to comment on that?

Mr. JONES. Everyone has to realize that while the FERC can dictate to the pipeline companies many of the conditions of regulation and give them policy direction and threaten them or impose on them penalties for failing to follow those directions, those contracts with producers are drawn within various States and subject to the laws of those States.

So that the litigation is going to be—with respect to the producer-pipeline litigation, this is going to be within the framework of the State statutes in the State under which the contract was drawn.

Mr. SMITH. If I may, Senator, I would just like to add a point. It hasn't been discussed very much this morning, but, as you are aware, if a pipeline company elects to follow the FERC's proposed transportation, open access transportation policy, its contract demand customers have the right to reduce their contract demand by 25 percent per year, and that is a very serious matter.

It puts the pipeline companies such as ours in dire straits. I was very pleased this morning to find that our friends the producers recognize the problem that the pipelines are facing on this. In our own case, to use rough numbers, approximately half of our market are served by customers who are partial requirements customers. We can well expect that they would elect to reduce their contract demand. That would have a very serious economic impact on us.

We think that there are serious questions about the legaility of that provision of the NOPR and all I wanted to do was supplement your opening comment about some of the important issues. There are a lot that we haven't discussed this morning. We have been focusing on just two or three; there are many more.

Senator BINGAMAN. Thank you very much, Mr. Chairman.

Senator NICKLES. Thank you, Senator Bingaman. Again, I appreciate your interest on this and I know it's very important to you and your State and I'll work with you on this as we continue trying to learn more to see if we can't influence FERC.

I heard a couple of different comments. This panel wasn't quite unanimous and I want to dwell on that. Mr. Dienstbier, your comments were more supportive of NOPR from any of the previous panelists that I have heard to date or for the last month.

Are you from the northern natural side or the Houston natural side?

Mr. DIENSTBIER. Very, very observant. Recently I assumed the position of executive vice president, responsible for all HNG/Internorth's gas pipeline operations, which includes northern natural gas.

Senator NICKLES. Are you from Omaha or Houston?

Mr. DIENSTBIER. At the moment I seem to be living on an airplane most of the time.

Senator NICKLES. I understand. Well, I'm going to ask you a question in a minute.

For the rest of our panel, I heard, Mr. King with NGAA, which represents most of the major interstate pipelines, that you have serious problems and reservations about the transportation; is that correct?

Mr. KING. Yes, sir.

Senator NICKLES. You have serious problems about block billing?

Mr. KING. Yes, sir.

Senator NICKLES. You have serious problems about the 25-percent abrogation of contracts or reductions on takes; is that correct?

Mr. KING. Yes, sir.

Senator NICKLES. Is that followed all the way down the line with Cities and with Mishwish and with El Paso and Tennessee Gas?

Mr. DIENSTBIER. And HNG/Internorth.

Senator NICKLES. And HNG.

Mr. DIENSTBIER. We indicated that there are modifications that are needed in the NOPR, but what we're trying, however, to do is focus on the fact that the FERC is trying to deal with reality and they're not dealing with it perhaps the way that I would deal with it or anyone else would.

But what we're trying to do is assist in what in fact is a critical issue, we believe, for the natural gas industry, is to inject some reality from the producer, the pipeline and the market standpoint. We're trying to take the position of saying there is a rightness, there is a purpose in what FERC is doing. We're trying to be supportive of that purpose.

We have violent disagreement with how that is done, as do, I think, everyone on this panel.

Senator NICKLES. Well, maybe I was making your initial statement more supportive of NOPR than originally. I don't disagree with their objectives. When you talk about having it more market oriented in moving gas and so on, I would tell you that I support that. I just totally disagree with the block pricing concept and then when you have thought all that through we have heard four of our panelists mention the sanctity of contracts, not wanting to abrogate contracts.

And I think Senator Evans—and I mentioned this when he left—there was a lot of discussion well, are we market price sensitive, and he's asking the producers do they want to be market price sensitive. I think any new contract is market price sensitive. I think that maybe a little bit of what was missing is that right now you have evolved through rolling in old prices and post-1974 prices or something together.

You have market price sensitive contracts, for the most part; old ones and new ones average out somewhere close to being on market. And if you segregate that 40 percent and totally isolate it, then you are going to be rolling back prices and abrogating of a major amount of contracts, which is going to have a serious cash flow impact on producers and and on their ability to sell. So you are going to be forced into that situation with your producers.

Now you, or possibly FERC, may be correct that in the long run that eventually that day would get here where you would move closer to a market, but you're going to have a massive disruption in both the supply side, the economies that are involved in the supply side in getting there. I am very concerned about that, and I hope to make some changes.

Am I not correct then there is a consensus in this panel that block pricing, as proposed, segregating the prices, and assuming oil gas is going to be forever regulated would be wrong? Would it be detrimental to your customers, to the consumers in the long term?

Mr. KING. Yes, sir.

Mr. DIENSTBIER. If I may add only one qualification, I agree with the general thrust of the rolled-in concept. Our specific comments, as I think you would see if you have an opportunity to look at our comments we filed, is that if it is determined that block pricing does in fact become what should be done is that there are different ways to do it to ensure that there is a real equity in what FERC was trying to do.

Generically and generally yes, we would agree with the other positions here.

Senator NICKLES. We haven't dealt too much with this panel or the previous panel, and I think three or four of you mentioned it to some extent. I'd like for you either as a group or individuals to respond on what impact the ability for the LDCs to get out of 25 percent of the contract per year, would have. I'd like to hear maybe a little bit more.

Most of the attention has been focused on block pricing. That's where I focused most of my attention. I can, I think, see more easily the negative implications of that. It's a little more difficult to follow through on the marketing-out or the 25 percent of abrogations or whatever. Could you give me an indication of how serious you think that would be?

Mr. KING. Well, two immediate impacts, Mr. Chairman. First of all, as proposed now a distributor can cut his contract demand 25 percent a year for 4 years on only 30 days' notice each year, which means that if that's a sizable volume the pipeline is sitting with a bag of unrecoverable costs until it can prepare or file a rate case for a rate increase, which in the normal course will take 6 to 9 months to take effect—6 months' suspension and about 3 months to prepare it.

That's one impact. The second impact is that those costs have to light somewhere and what will happen in the rate case is that they will be shifted to other companies of the pipeline who, for whatever reason, cannot reduce their contract demands. So it has an adverse impact on those other customers as well as the pipeline itself.

Senator NICKLES. Mr. Ramsey.

Mr. RAMSEY. Just to follow up on that point, what happens when that occurs is that the small municipalities are the ones that are going to have to pay a lot more costs that some of the larger distribution companies may be able to avoid as they escape 25 percent of their contract with the pipeline. I guess another big problem with that is from the pipeline's point of view, is how in the world are we going to know how much gas to go out and contract for when our system is sitting out there able to reduce its demand by 25 percent per year for 4 years. Do we buy any?

Those sorts of operational and planning considerations are what have us worried about being able to maintain long-term reliable service to those customers when there's no corresponding obligation on their part. They can walk 25 percent of the contract, so how do we plan to buy gas, and that's sort of the environment.

Senator NICKLES. The proposal, does it call for the initiation of the 25 percent reduction to be made by the LDC?

Mr. RAMSEY. Yes.

Senator NICKLES. Not initiated by the pipeline?

Mr. RAMSEY. That's right, strictly at his option. It's at the pipeline's option, I believe, if he is allowed to return at any time, should he request to go back up on his sales contract.

Senator NICKLES. Are your contracts with the LDCs, are they long-term contracts?

Mr. KING. Yes, sir.

Senator NICKLES. Long-term fixed?

Mr. KING. Well, the price, of course, is subject to change and they can be amended as to volumes, but normally our contracts with the LDCs are long-term contracts.

Mr. RAMSEY. All of Tennessee's run to the year 2000. Our obligation to serve is through the year 2000, that full contractual quantity.

Senator NICKLES. Mr. Jones?

Mr. JONES. Some are not actually contract demand type arrangements, but in some instances—and I believe they are in the minority as far as the total business is concerned—are our requirements type contracts where there is really no definition other than the total requirements, which are not really dealt with in the NOPR in its present form.

Senator NICKLES. So I see almost a unanimous panel again for opposition on block pricing, opposition on the 25 percent market out or whatever provision.

Now I think I'm seeing some disagreement. Since the court's decision that basically prohibits the special marketing orders most of you are moving probably a fairly substantial amount of gas under those type of orders. I heard all of the producers saying we need some type of a mechanism to help us get that availability to be able to move gas, and so they were generally supportive, maybe not in minute detail, but in the carriage provisions under NOPR.

Is there a division or was I incorrect? Do you support maybe something close to what NOPR was trying to do as far as the transportation rules?

I'd like each of you to answer that.

Mr. SMITH. I would like to say we do not support the transportation proposal. As I mentioned, it's the conditions that are imposed upon us as a result of electing to take that. It is offered by the Commission as an option, but in fact it is very close to a mandatory provision.

Senator NICKLES. Are you sitting there with a gun at your head?

Mr. SMITH. I think it would be possible to provide the type of transportation that the market needs by private negotiation and with perhaps some modification of FERC policies, but we don't have to completely restructure the industry with all of these conditions while we're doing that, and I think we need to scrub the baby, not throw it out with the bath water.

Senator NICKLES. You think it's too close to being mandatory?

Mr. SMITH. It's very, very close to being mandatory. I think the courts would probably so view it.

Senator NICKLES. I've had a lot of people tell me that in my State and Texas and other States right now we're moving one heck of a lot of gas, and if we don't have some type of vehicle like that we're not going to be moving in as much gas.

Mr. MORRIS. El Paso agrees with the comments that Mr. Smith just made. We oppose it in its present form. I think it would be fairly simple, though, for the FERC to go back to its blanket authorizations that were struck down by the courts recently and amend those to meet the nondiscriminatory access.

Senator NICKLES. If they put in nondiscrimination clauses and made them a little broader and more general, then that would allow just a blanket order to where you couldn't move gas? Is that a consensus?

Mr. JONES. I would agree with that. One of the real tragedies of NOPR is that the pipeline industry, the interstate pipeline industry, is moving very rapidly to provide transportation, and again one of the problems with the NOPR is they attempt to deal with all situations in a generic fashion, and there is a difference, and a big difference, between different pipelines that operate in this business and this country.

And they are ignoring the fact, I think, when they designed those provisions, that there is a system working out there. True, they've got a court problem, but I agree with Mr. Morris that that can be solved by simply restructing that thing so that it will comply with the requirements of the court and again put back into the market something that the pipeline companies, its producers and its customers have started using to a very great extent to solve the problem.

Mr. KING. Last spring my company filed a set of comprehensive transportation proposals that would accomplish everything that is the goal of the NOPR and would have done it all within the framework of the general regulatory system. It did not require this radical change that the NOPR is proposing.

Senator NICKLES. One question. We've heard from, I think, FERC or they have stated before this committee and written as well that these proposals were integrated. I have been suggesting that they be split and come up with some transportation orders or something. Most of you agree that they could be split?

Mr. KING. No, sir, I do not.

Senator NICKLES. Wait a minute. I want to make sure, Mr. King, I get this. Do you agree that they could split and come up with some type of a marketing order—I thought that's what you just finished saying—outside and not go into all the billing procedures and maybe the abrogation or the 25 percent market out.

Mr. KING. It is possible to attack these problems individually, yes, sir, in that sense, but in terms of the NOPR as it stands right now I don't believe that you can just take portions of it out. I think it was conceived as an integrated proposal and the individual parts will not stand, as presently written, alone.

Senator NICKLES. I understand that. But the thrust of my hope or desire would be that maybe if we're moving toward a consensus out of these hearings and we have representatives here from FERC that they will move forward with some accommodation. Several of you have mentioned that you have had some suggestions for transportation modes, blanket orders, or whatever that would accommodate the court's, basically, I think, decision that says by the end of October you have got to do something else and maybe limit the order to that extent.

Mr. KING. That's correct.

Senator NICKLES. I appreciate it.

Mr. DIENSTBIER. I'd like to amplify on that, if I could, and we, like others, move a lot of spot gas today, probably running about 1.5 billion cubic feet a day in all of the systems. The issue here on the transportation and its severability from the NOPR goes back to the issue of the level playing field.

We hear a lot about level playing fields when it comes on both ends of the equation. One of the concerns of a pipeline company is to make sure that from the wholesaler's role, if you will, that there is a also a level playing field. If, independent from all other factors, a transportation would to be freed up totally in the sense of free access from supply to market, the pipeline at the same time, however, has those service obligations Mr. Ramsey mentioned, and the gas contract obligations at the same time.

That's the issue of that's not a level playing field either, and I think that's one of the considerations that hopefully needs to be made as this whole issue is dealt with.

Senator NICKLES. One final question and the same final question I asked the other panel. If FERC stayed pretty much with NOPR as stated, would you have recommendations for, one, do you see it in the courts or, two, what do you suggest that Congress do?

Mr. DIENSTBIER. Let me offer something, if I can. I think one of the ideas—and whether or not this is doable in view of the court mandate or not is beyond me, I guess; I'm not an attorney—one of the things I think there would be a great deal of support for is to as the new or revised rulemaking comes out, which may be shortly, I would think it would be worth the time if that time were available to take a second look at what modifications had been done from both the producer and pipeline and the distributors.

Now you may not have that time. I think that would be a worthwhile step to take another shot at making it a more workable document.

Senator NICKLES. you want to say something, Mr. Smith?

Mr. SMITH. I was going to agree with your summary, that I think it will be litigated extensively for a long period of time, and we would hope that if it comes out anywhere near originally proposed that the Congress would take action by adoption of a resolution or other appropriate action to send a different message back to the Commission.

Senator NICKLES. Thank you very much. To all of our panelists, we appreciate your participation. I think you have made a valuable contribution to the hearing.

Our next witness is Mr. Louis Reif, president of the National Fuel Gas Co. and also chairman of AGA.

STATEMENT OF LOUIS R. REIF, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUEL GAS CO., AND CHAIRMAN, AMERICAN GAS ASSOCIATION

Mr. REIF. Mr. Chairman, I am Louis Reif, president and chief executive officer of the National Fuel Gas Co. Today, however, I am speaking in my capacity as chairman of the American Gas Association, which represents some 300 gas distributors and pipelines.

Let me begin by stressing AGA's view that the current gas supply outlook is excellent for both the short and long term. Lower 48 reserve additions have risen from only 46 percent of production during the pre-NGPA period of 1968 through 1978 to 96 percent of production from 1981 through 1984. The 1984 reserve addition numbers show a lower replacement rate that is due almost entirely to negative net adjustments of past reserve estimates.

More than half of these adjustments were in four low production States, but we do not discount the downward adjustments. Nevertheless, we believe that the real news is that gas discoveries rose by 18 percent and new field discoveries rose by 61 percent at a time when prices for marginal new gas were declining.

You have asked us to respond to four specific questions in our testimony. One, would the public interest be better served by retaining the existing regulatory system? As things now stand, I would have to say yes. We have a situation where all segments of the industry are beginning to work themselves out of the transition from a regulated fuel price market into a more competitive end use market.

The supply situation has improved dramatically. Prices are stabilized and indeed are declining. Demand is increasing and if we could get rid of the Federal statutory market restraints it would increase dramatically. And here I would like to say that I would vigorously disagree with previous witnesses. The Fuel Use Act and title II of the NGPA seriously impact the gas industry's ability to provide more of the United States' primary energy.

I think with the acid rain situation becoming more and more aggravated natural gas could be burned in many of the Ohio steam generating plants and alleviate the air quality problems that we have today in the eastern part of the United States.

Increased demand would alleviate some of the problems plaguing the industry such as weak spot prices for sellers and a very significant take-or-pay problem for buyers. Also, negotiated carriage arrangements are increasing sharply. These are voluntary arrangements which can also help to increase demand. So a lot of things are happening which show the industry responding in a constructive way to the current situation.

The arrival of the NOPR, with its potential for massive structural changes of the gas industry, which could be viewed as rushing into fix an industry that isn't broken, is coming at a very bad time. Indeed, we contend that the NOPR as now proposed would be counterproductive to the industry's effort to work its way toward the goal which everyone—FERC, producers, pipelines, distributors, and end users—want to achieve; that is, more responsiveness throughout the system, from wellhead to burner tip to competitive market conditions.

Two, would the NOPR create a regulatory system that would be operationally workable and legally sound? As currently proposed, the NOPR would pose serious operational problems and serious grounds for legal challenge. A number of speakers have talked about that. If constructive recommendations for change were adopted, both the operational problems and the legal questions can be significantly improved.

However, there can be no guarantee. Only time will tell as to the ultimate workability and legality. For example, the bypass proposed, as proposed, is, in our judgment, in violation of the Natural Gas Act and constitutes a serious threat to the LDC markets.

Now I'm going to combine three and four, question three and question four. Would the NOPR create a regulatory system that would assure residential, commercial, and industrial customers reliable long-term supply at the lowest possible cost and what impact would the regulatory system the NOPR proposes to create have on exploration?

So long as market forces are not distorted by reimposed wellhead price controls or indefinitely continued gas use restrictions at the burner tip, the market can draw upon a gas resource base that is more than ample enough to handle contingencies. Thus, gas supply availability is in less danger from the NOPR than from the continuing congressional reluctance, for example, to repeal the Fuel Use Act. These statutes undercut supply by dampening the demand pull effect.

Turning to some specifics on the NOPR as now proposed, FERC's block pricing scheme would render much pipeline gas unmarketable. Again, other speakers have addressed this question. At the same time, FERC has proposed no new contract renegotiation tools except a take-or-pay or buyout mechanism that would be marginally effective at best. Any drop in average pipeline costs would be wiped out by additional take-or-pay for charges. These combined factors and the NOPR as proposed might prompt numerous pipelines to move away from firm sales and suspend new fuel purchases at least temporarily. This could cause transitional confusion, perhaps inducing delays in drilling activity.

Also, revenues for some producers, especially independents, would be cut by a probable decline in the average unit cost paid by the pipelines. However, these negative effects on the producer could be offset by higher spot market prices and by increased carriage and higher takes due to higher overall gas demand.

There are other effects. Even a temporary pipeline shift away from firm sales could adversely affect the cost and/or reliability of service for those gas consumers who continue to depend on gas distributors. Most distributors cannot easily duplicate pipeline load balancing and bulk purchasing capabilities. Small distributors cannot duplicate the pipeline capabilities at all.

The market continues to want some significant level of firm pipeline sales, but pipelines cannot respond effectively until they achieve a climate more receptive to contract renegotiation. The

NOPR can be restructured to ease this problem instead of aggravating it.

AGA advocates subdividing the proposed block 2 into two categories, block 2A for market sensitive gas, and block 2B for rigidly above market gas. This would reward market responsive producers with higher takes while making those incentives more obvious to producers who have been reluctant to renegotiate and address market responsive conditions.

As for take-or-pay relief, AGA has urged the Commission to pursue less costly and more flexible alternatives to the proposed buyout approach. None of these alternatives involves contract abrogation and none of these alternatives provide the ultimate answer to the major and abiding problem of take-or-pay. The only ultimate solution is to sell more gas, and that is something the committee can play a leading role in, as I said earlier, by pushing for repeal of the Fuel Use Act and incremental pricing. We urge the committee to view this as a compelling legislative priority.

Thank you.

[The prepared statement of Mr. Reif follows:]

TESTIMONY OF

LOUIS R. REIF,

PRESIDENT AND CHIEF EXECUTIVE OFFICER

OF NATIONAL FUEL GAS COMPANY

AND CHAIRMAN OF THE

AMERICAN GAS ASSOCIATION,

BEFORE THE SUBCOMMITTEE ON

ENERGY REGULATION

AND CONSERVATION

OF THE

UNITED STATES SENATE

ON THE IMPACT ON NATURAL GAS SUPPLIES

OF THE FEDERAL ENERGY REGULATORY COMMISSION'S

NOTICE OF PROPOSED RULEMAKING

September 19, 1985

INTRODUCTION

Mr. Chairman and members of the Committee:

My name is Louis R. Reif, and I am President and Chief Executive Officer of National Fuel Gas Company. My company is based in Buffalo, New York, and operates primarily as an integrated gas distribution and transmission company in both New York State and Pennsylvania. My company is also engaged in some natural gas production activities.

Today, however, I am acting in my capacity as Chairman of the American Gas Association (A.G.A.). Speaking on behalf of that organization, I am pleased to have this opportunity to address the impact on natural gas supplies of the Notice of Proposed Rulemaking (NOPR) that the Federal Energy Regulatory Commission (FERC) has recently issued.

A.G.A. is a national trade association which is composed of nearly 300 natural gas companies in all 50 States. Collectively, our member companies account for 85% of the nation's gas utility sales. A.G.A. represents all segments of the regulated gas industry: distribution companies, interstate pipelines and intrastate pipelines alike. Therefore, A.G.A. is in the unique position of being able to give the members of this Committee the perspective of the entire distribution and transmission industry, not just the views of one segment of the industry.

My testimony today will be presented in two stages. The first portion will be a discussion of the overall gas supply outlook as it stands today, outlining in detail our reasons for concluding that both the short term and long term supply outlooks are excellent. The second portion will be a discussion of how the FERC's NOPR might affect this gas supply outlook. In this portion of the testimony we respond to four questions from Senator Nickles; we also discuss in detail our reasons for concluding that the current version of the NOPR will not materially impair overall supply availability but might adversely affect the cost and/or reliability of distribution company service.

THE CURRENT GAS SUPPLY OUTLOOK

Let me begin with the obvious. It is almost universally recognized that the short-term gas supply outlook is good. In fact, it is so good that we literally have an "embarrassment of riches" at the moment: an excess gas production capacity so large that it is causing market distortions, such as reduced drilling activity and high take-or-pay liability for many interstate pipelines. A.G.A. estimates that gas deliverability -- that is, the maximum amount of gas that can be produced under normal operating conditions -- currently exceeds the actual level of production by 2.9 trillion cubic feet (Tcf) in the lower 48 States alone. This is a surplus supply of over 15%, before additional excess deliverability in Canada and Mexico is considered. We expect that, under current conditions, some degree of excess deliverability is likely to continue through the rest of the decade.

While numerous observers differ on the exact extent and duration of this excess deliverability, there is little dispute that the magnitude of this surplus is considerable. Its existence has literally become a fact of industry life.

Unfortunately, opinions are not so uniform when it comes to the long-term gas supply outlook. For its part, A.G.A. has long maintained that the domestic gas resource base is large enough to meet any reasonably foreseeable future gas demand. Our viewpoint is firmly grounded in two realities.

1. The first foundation for our viewpoint on long-term gas supply is a record of lower 48 reserve additions which clearly shows that the natural gas shortages of the 1970's were a creation of below-market wellhead price controls -- not the natural result of a declining resource base. The phased removal of price controls on new gas, under the Natural Gas Policy Act of 1978 (NGPA), has demonstrated unmistakably what free market prices at the wellhead can do. For the period of 1981 through 1984, reserve additions in the lower 48 States have averaged over 96% of production; by contrast, during the pre-NGPA period of 1968 through 1978, lower 48 reserve additions averaged only 46% of the replacement rate.

The Energy Information Administration's recently released reserve figures for 1984 show that lower 48 reserve additions fell roughly 3 Tcf short of production -- reaching only 82% of the replacement rate. The shortfall, however, was almost entirely attributable to negative net adjustments of reserves. This category of corrections shifted from upward adjustments of 3.1 Tcf in 1983 to downward adjustments of 2.2 Tcf for 1984: a very unusual swing of 5.3 Tcf in one year. Further, more than half of the downward adjustments were concentrated in only four States -- Michigan, Ohio, Pennsylvania and Colorado -- which cumulatively account for less than 4% of the nation's proven gas reserves.

A.G.A. has traditionally counted upward adjustments in evaluating reserve addition trends, and we do not discount the downward adjustments of 1984. Nevertheless, we do feel that the _real_ news is that discoveries of marginal new gas increased while marginal prices were declining. Newly discovered gas rose by 18%, from 11.4 Tcf to 13.5 Tcf; discoveries of gas in _new_ fields increased by an amazing 61%, from 1.6 Tcf to 2.5 Tcf.

Indeed, there may be important lessons to be learned from speculating how this surprising event was able to occur. We must add a cautionary word that our analysis is inherently blurred by the "time lag" factor: that is, the fact that many of the gas finds in 1984 actually reflect drilling decisions made in 1983 or earlier. However, because 1984 only continued drilling environment trends that began as early as 1982, some generally applicable observations can be offered.

The _first_ lesson may be that it can be misleading to look solely at the absolute price level which prevails at the wellhead. In the final analysis, the producer is not motivated by price; the producer is motivated by profit. He calculates this profit by taking his total revenues -- that is, the price per unit times the total number of units sold -- and then subtracting his total costs.

Thus, while the itemized sub-factors can number a multitude, the producer's basic profit calculation pivots on three fundamental variables: unit price, number of units sold, and total costs. In 1984, only one of these variables -- unit price -- changed adversely for the producer; the other two variables changed for the better. Costs were down, due to a combination of greater producer efficiency -- sometimes through the use of better technology -- and a continuing trend toward dramatically reduced charges from drilling contractors and equipment suppliers. At the same time, a 9% rise in lower 48 gas production -- which, under current market conditions, means a 9% increase in the demand for lower 48 gas -- offered at least the hope of selling more units of gas from a newly drilled well.

The probable role played by these factors is a hopeful sign for gas consumers and gas producers alike. Producers have displayed an impressive ability to reduce their costs in the face of adversity; to the extent that, in the future, they can initiate cost reductions which are larger than the size of any revenue reductions, they can wring from "hard times" the equivalent of a net price increase -- without requiring gas consumers to pay for one. Further, the apparent supply response to higher demand constitutes evidence that a "demand pull" effect does exist. This in turn offers hope that, in the future, at least some degree of gas demand growth can be accommodated without a requirement for higher prices -- because the higher demand itself will constitute the supply incentive of increased total revenues for producers.

The second lesson we can learn is less speculative. It is the lesson that when producers go looking for gas, they may find more than they expect.

The 1984 experience in the offshore Gulf of Mexico region provides the best example of this. Presumably spurred by falling marginal prices, drilling activity has in recent years turned increasingly to the Gulf of Mexico -- where the appeal of traditionally high rates of gas flow demonstrates again that the producer looks at both unit prices and the number of units that can be sold. This swing of drilling activity toward the Gulf prompted some flurries of supply pessimism -- because the Gulf, having been explored so intensively for so long, was widely viewed as a "mature producing region" that was overdue to begin the long downward march toward eventual depletion. Then came the surprises, including exciting finds in Mobile Bay and even a stunningly high-yield well in a portion of the Gulf that was long thought to be virtually depleted. In the end, the Gulf turned out to be the banner region of 1984 -- hitting a regional replacement rate of 120%.

The implications for the future are obvious. If the Gulf of Mexico -- the most intensively explored, and the most intensively produced, gas-prone region in the country -- could surprise everyone with its remaining potential for new gas discoveries, there is every reason to hope for even more pleasant surprises when higher drilling activity returns to regions which have been less extensively explored.

Looking at the 1984 reserve additions as a whole, we were surprised by the size of the downward adjustments which caused the net decline in the overall replacement rate. Yet we believe that, in the long run, the gas industry will not remember 1984 for its unexpected downward turn in net reserve adjustments. The industry will instead remember 1984 as an historic watershed year when, for the first time in literally decades, new gas discoveries went up while marginal prices went down -- providing dramatic evidence that rising reserve additions do not automatically depend upon rising prices.

2. The second foundation for our viewpoint on long-term gas supply is a growing recognition, within the regulated gas industry, that the recoverable resource base for natural gas is not some fixed quantity of gas in the ground. It is not like a bank account from which we continually make withdrawals until the account is someday depleted. The recoverable resource base is, rather, an

elastic quantity of natural gas -- expanding and contracting with changes in price incentives and technology. It resembles not a bank account but a reservoir -- which can be made larger over time as the need for more water arises.

Let me give you some examples of what can happen. In 1938 -- the year that the Natural Gas Act became law -- the deepest onshore well ever drilled was 15,004 feet. In the ensuing decades, drilling technology has advanced to the point that the latest onshore depth record is 31,444 feet: more than twice the depth reached 47 years ago. Technological progress in the offshore areas has been even more dramatic. Offshore areas were not even technologically accessible in 1938, but by 1965 gas drilling had occurred in waters as deep as 632 feet. By 1984, the record depth had reached 6,448 feet of water -- a more than tenfold increase from the record depth of 20 years ago -- and drilling technologists are now reporting that wells in 10,000 feet of water are theoretically possible. Needless to say, the recoverable resource base has grown with these improvements in exploration and production technology.

To cite another example, 10 years ago the tight sands formations of our nation were beyond the gas industry's technological reach. Now, because of technological advances in the past decade, some of these formations have become economically producible -- and are in fact now contributing significantly to the nation's overall gas production. The Potential Gas Committee, a recognized group of supply experts, has reviewed changing estimates of the recoverable resource base and has determined that 172 Tcf of tight sands gas is now classified as "recoverable" through the direct impact of this new technology.

The Potential Gas Committee sees a huge margin for further expansion of the resource base through new technology. In a study released this month, the Committee estimates that, without including any gas found in Alaska or elsewhere outside the lower 48 States, the resource base that is currently recoverable -- that is, recoverable with currently foreseeable technology and economics -- reaches 810 Tcf. This currently recoverable resource base includes 163 Tcf of proven reserves plus an estimated 647 Tcf of presently undiscovered gas. The total gas involved is roughly 47 times the actual lower 48 production level in 1984.

Impressive as this number is, however, it could be easily expanded if technology develops beyond the currently foreseeable level. For example, the recoverable resource base could be significantly expanded through drilling technology improvements that are now considered possible in the areas of Western tight sands formations, Eastern Devonian shale formations, and gas reservoirs within coal seams. When we move into the more exotic gas sources that would require a genuine research breakthrough -- such as gas in geopressured zones, gas hydrates, abiogenic gas (formed through chemical interactions in the earth rather than fossilization), and biomass -- we may be looking at a total natural gas resource base that is several thousand times our current gas consumption level. Indeed, with a research breakthrough in any of these "exotic" areas, gas could conceivably eclipse coal as America's most abundant energy resource.

In short, there was a time when many of us in the regulated gas industry used to look at the gas production rates and nervously ask ourselves: How much undiscovered gas is left in the ground? Now we are more sophisticated. Now we have learned to ask the important follow-up questions: How much undiscovered gas is left -- at what price? With what level of technology? The size and features of the recoverable resource base are sculpted by the two tools of price and technology -- and these two tools are powered in turn by the mighty engine of the market's need for gas. As the need for more gas rises, the requisite prices will be offered and the requisite technology will be developed (with some very welcome assistance from each year's Federal R&D budget). The margin for expanding the current resource base, through market-driven price and technology, is clearly tremendous. Thus, if you ask us: How much undiscovered gas is left in the ground?, we can safely reply: How much do you need?

There is, however, a weak link in the chain of market signals that assures adequate gas supplies. As I noted earlier, price and technology are the tools for bringing more gas on line -- but the market's need for gas is the engine that drives these tools. It is imperative that government do nothing to tamper with this engine. During the 1950's through most of the 1970's, the Federal Government experimented with lowering the horsepower of the engine; by imposing wellhead price controls, it distorted the market signals, sending the burner tip a message to increase gas consumption while sending the wellhead a message to decrease gas production. The result was a painful piece of history. Now the Federal Government is experimenting on the engine more directly -- using the Fuel Use Act and incremental pricing to artifically depress burner tip gas consumption, which sends to the producer a message that the market's need for gas is less than is actually the case. While the gas supply situation has been strong enough to withstand the negative impact of these demand constraints, reserve additions have undoubtedly been lower than they would have been if the wellhead had been responding to the true level of gas demand -- instead of responding to a demand level that has been artificially depressed.

This concern leads us directly to the NOPR.

IMPACT OF THE NOPR ON NATURAL GAS SUPPLIES

The NOPR, as presently structured, offers a disturbing potential for distorting -- at least temporarily -- natural market forces. We do not believe that it is likely to seriously impair the overall availability of natural gas supplies, but we are concerned that it could artificially distort -- and perhaps even eliminate, at least temporarily -- the role that pipelines currently play in acquiring marginal new gas supplies.

The NOPR could have this effect by generating a "one-two punch" for interstate pipelines.

As the first punch, such pipelines -- after having slowly begun to make some headway toward renegotiating wellhead contracts and bringing prices downward -- would be saddled with a punitive block pricing mechanism.

Currently, interstate pipelines roll together inexpensive old gas, "market-sensitive" new gas, and other gas that is well above market -- offering all of this gas at a single, somewhat marketable average price. The NOPR proposes, however, that pipelines should offer a separate Block 1 of gas, which would be reserved solely for existing firm pipeline customers (principally distributors) and would consist of price-controlled old gas that is well below market. All other gas -- new, deep and tight sands -- would be placed in a separate Block 2; the price of this gas would be considerably higher, because the "market-sensitive" gas within it would be averaged in with above-market gas and would not be averaged in with any below-market old gas. Distributors, and other existing firm pipeline customers, would then be able to select the volumes they want to take from each block. For example, a distributor served by three different pipelines could take from each one its maximum entitlement of Block 1 gas -- meeting most of its requirements with these below-market supplies -- and then reject all of the Block 2 gas offered by each pipeline, making up the difference through pipeline carriage of relatively inexpensive spot market gas. Such developments could leave pipelines with virtually all of their Block 2 gas unsold, while still owing a steadily expanding of money to producers under take-or-pay obligations for this gas.

It is also worth noting that new firm pipeline customers, as well as existing interruptible pipeline customers, would have no claim to inexpensive Block 1 gas. They would have to choose between a flow of high-priced Block 2 gas from the pipeline and the alternative of pipeline carriage for spot market gas.

In short, by lumping "market-sensitive" pipeline gas together with above-market pipeline gas, and simultaneously permitting existing firm pipeline customers to reject the entire block of new gas, the current version of block pricing would generally make all Block 2 gas difficult to market. This would place interstate pipelines back somewhere behind Square One in their efforts to achieve market-responsive prices.

As the second punch, the Commission would fail to give interstate pipelines the tools that they need for restoring competitiveness through contract renegotiation. We recognize that the Commission has made an effort to assist pipelines by proposing a "buyout" mechanism. Under this approach, the Commission would select, as a "buyout" payment ceiling, a currently unspecified percentage of the take-or-pay liability that pipelines expect to incur in the future. Any pipeline settlements which do not exceed this ceiling would be rebuttably deemed "prudent", enabling pipelines to initiate automatic recovery of these settlement sums in their rates.

Unfortunately, the proposed "buyout" formula would not -- in our view -- be an effective renegotiation tool. Apart from the fact that the proposal addresses only future take-or-pay liability, leaving unresolved literally billions of dollars of existing take-or-pay liability, there are other serious flaws. Producers would tend to see the ceiling on "buyout" payments as a floor, leading in many cases to unnecessarily expensive settlements; in other cases the ceiling might be too low to permit settlements to occur; and, in general, the pipeline take-or-pay liability that must be settled is too large for "buyouts" to handle it all for any kind of financially acceptable sums.

Indeed, the NOPR's block pricing mechanism -- by rendering unmarketable a larger portion of pipeline supplies -- would probably increase the amount of take-or-pay liability that pipelines must resolve. Further, because both take-or-pay "buyouts" and increased pre-payments for remaining take-or-pay liability would be recovered from pipeline customers, the recovery of take-or-pay expenses could easily offset -- or even more than offset -- whatever unit price reductions can be obtained through wellhead contract renegotiation.

In short, over the near term, rates for pipeline firm sales would be likely to stay where they are now. With interstate pipelines then facing increased take-or-pay liability on increased volumes of unmarketable gas, numerous pipelines might decide to adopt at least a temporary strategy of suspending new field purchases, attempting to abandon firm sale arrangements as contracts with existing customers expire, and limiting new contracts to carriage arrangements only.

As we noted earlier, this development might not significantly affect the overall availability of gas supplies. Overall supply stability could result from the fact that both negative and positive effects on producers would be at work.

As a negative factor, widespread pipeline decisions to suspend new field purchases might create a period of confusion at the wellhead, which might in turn tend to delay new drilling activity. In addition, revenues for some producers -- especially independents -- would be cut by a probable decline in the average unit price paid by pipelines.

However, positive supply forces would be at work in the form of higher spot market prices (induced by increased carriage) and higher average "takes" due to higher overall gas demand.

We cannot quantify either the negative or the positive supply impacts, but the two trends would tend to neutralize each other -- leaving overall supply availability largely unaffected. We also stress the probability that the downward pressure on wellhead prices would be generally focused on existing gas supplies under long-term contracts, rather than on less expensive marginal gas supplies from new drilling.

Nevertheless, the identity of the field purchasers could change, with the vacuum left by interstate pipelines being filled by direct purchasers.

This development would cause us great concern -- because few gas distributors, if any, want to rely exclusively on their own field purchases as the sole source of their gas supplies. There are good reasons why most distributors view field purchases as only a secondary source of supplies. Most distributors cannot easily duplicate -- without higher costs and/or administrative complications -- the storage facilities of pipelines; they cannot easily duplicate the multitude of wells that pipelines can draw upon to compensate for operational problems with a particular well or field; they cannot easily duplicate other load-balancing mechanisms which pipelines have at their disposal. Nor can they always duplicate the steadiness of the minimum wellhead "takes" that pipelines can offer to a producer: a disadvantage which could force distributors, in any intense competitive bidding at the wellhead, to pay producers a premium unit price in order to offset the lower rate of guaranteed unit sales each month.

Serious as these problems would be for distributors in general, they would be particularly severe for the nation's many small distibutors. Such distributors would be buying gas on too small a scale to carry much weight at all in competitive bidding at the wellhead -- and they would be far too limited in financial resources to even consider investments in storage facilities or diversified sources of wellhead production.

In short, the present version of the NOPR would probably not have a significant negative impact on overall gas supplies -- but it could easily have a major negative impact on the cost and/or reliability of service for the vast number of gas consumers who will continue to depend upon the nation's gas distributors. This potentially negative impact can be avoided, however, if the NOPR can be restructured so that it enhances pipeline efforts to restore the competitiveness of pipeline firm sales. The market has a natural interest in some significant level of continuing firm pipeline sales, but such sales must regain a competitive standing before pipelines can respond effectively to this market interest.

The basic problem, in keeping pipeline firm sales competitive, is that most interstate pipelines are burdened -- to a greater or lesser extent -- by a large pool of gas that is being held rigidly above market by existing contracts. If block pricing takes the form proposed and this pocket of above-market gas cannot be brought down to a marketable level, numerous pipelines may find it difficult to compete with even high-priced firm carriage -- or with anything else.

If the Commission is to avoid pressuring interstate pipelines into at least temporary departures from their traditional "merchant" role, the Commission cannot blithely assume that simply intensifying the competitive pressures on pipelines will somehow magically dissolve legal obligations at the wellhead. The Commission must instead provide interstate pipelines with adequate tools for pursuing the goal of contract renegotiation.

A.G.A. has recently commissioned Foster Associates to study the dimensions of the contract negotiation problem. We asked them to focus on interstate pipeline volumes which fall into one of two high-priced NGPA gas categories: Section 102 (which is new gas from new fields) and Section 107 (which is mainly deep gas and tight sands gas). We also asked Foster Associates to sub-divide these gas volumes into two classes: a) pre-1982 contracts with a current price of at least $3.80 per MMBtu's; and b) all other Section 102 and 107 gas, which was presumed to be "market-sensitive".

Foster Associates reported back to us in August, indicating that about half of the Section 102 and 107 gas falls into the above-market class. (A copy of this study is attached.) This above-market gas accounts for over 10% of all the gas purchased by interstate pipelines -- and it has an average wellhead price of $4.49 per MMBtu's. This compares with an average price of $3.78 per MMBtu's for Section 102 and 107 interstate gas volumes as a whole; $3.02 per MMBtu's for "market-sensitive" Section 102 and 107 interstate gas volumes; and $2.64 per MMBtu's for all interstate gas.

From these pricing numbers, it is clear why "market-sensitive" gas should not be lumped together -- in any block pricing scheme -- with other gas that is far above market. When the two halves of NGPA Section 102 and 107 production are rolled together in the proposed Block 2, the $4.49 gas is averaged downward to $3.78 -- which is still an unmarketable price level. The "market sensitive" gas, which was somewhat marketable at $3.02, is now averaged upward to $3.78. The pipeline, which might otherwise be able to sell at least the "market-sensitive" half of its NGPA Section 102 and 107 production, may now be unable to sell any of it.

Unfortunately, the natural process of contract expiration will not substantially ease this problem for quite some time. According to the Foster Associates study, 87% of the above-market contracts will still be in effect in 1990 -- and 26% will still be in effect in 1995. Thus, if interstate pipelines are not given adequate tools for contract renegotiation, this pocket of above-market gas could be distorting pipeline prices well into the future.

Another implication should also be noted. Because the above-market gas volumes involved are so large, and the take-or-pay unit prices owed to producers are so high when this above-market gas is untaken, the cost of resolving all take-or-pay liability through "buyouts" would be exorbitantly expensive -- if, indeed, such a goal could be accomplished at all.

So much for the bad news. The good news is that there is hope for resolving the problem -- through adoption of some conceptually simple A.G.A. recommendations.

Specifically:

a. The problems posed by the proposed Block 2 can be eased by simply sub-dividing Block 2 into two sub-categories: Block 2a, which would be composed of gas under contracts that are "market-sensitive" and/or that post-date the effective date of the new rule; and Block 2b, which would contain gas under existing contracts that are not "market-sensitive". Through this simple step of sub-dividing Block 2, block pricing could be turned into a tool for rewarding, with higher "takes", producers who have agreed to "market-sensitive" contracts--and for making these incentives more obvious to "holdout" producers who are clinging to rigidly above-market gas.

b. As for take-or-pay relief, we have urged the Commission to pursue less costly -- and more flexible -- alternatives to the proposed "buyout" approach. These alternatives include:

1) Making take-or-pay relief a pre-condition for producer access to blanket certificate transportation.

2) Making take-or-pay relief a pre-condition for expedited release and abandonment.

3) Permitting pipelines to give producers who have negotiated "market-sensitive" contracts a priority access to blanket certificate transportation.

4) A Commission ruling that, where make-up of untaken price-controlled gas volumes is unlikely, take-or-pay liability is voided to the extent that such payments would lead to unit prices per MMBtu's that exceed the applicable NGPA price ceiling.

None of the above approaches involve contract abrogation.

Further, to the extent that "buyouts" remain necessary, the Commission should drop both the presumption of "prudence" and the uniformity of a formula. This policy -- which is basically a continuation of the FERC's currently established treatment of take-or-pay "buyouts" -- would increase negotiating flexibility and avoid the likelihood of a ceiling on "buyout" payments that producers will see as a floor.

c. A higher ceiling on interruptible carriage rates may also improve the competitiveness of firm pipeline sales. Under the present proposal, we anticipate a substantial increase in interruptible pipeline carriage. However, when we examine the NOPR's proposed interruptible carriage rates, the maximum rates appear to permit no opportunity for pipelines to earn any profit margin at all on the growing number of interruptible carriage transactions. Under such a rate scheme, pipelines must either lower their overall profit goals or press for higher profit margins on firm carriage and firm sales. If profits can be earned on interruptible carriage, however, there will be less upward pressure on firm sales rates.

RESPONSES TO QUESTIONS FROM SENATOR NICKLES

In light of the preceding discussion, we can respond to four specific questions that Senator Don Nickles has asked us to address in our testimony. These questions were posed in a September 9, 1985 letter to Michael Baly III, A.G.A.'s Vice President for Government Relations.

1. Would the public interest be better served by retaining the existing regulatory system?

Our answer depends on how the final rule, and possible subsequent rules and regulatory policies, are structured and implemented. If properly designed and implemented, in a manner which reflects responsiveness to constructive concerns and recommendations, the new rule offers the prospect of public policy guidance which will permit our member companies, during this period of transition, to better serve existing customers as well as a growning new market. However, if improperly designed and implemented, it could result in an unwarranted restructuring of the natural gas industry, with an unnecessary adverse impact on these same customers and new market opportunities.

A key concern of ours is that the government should not rush in to fix an industry that isn't broken. If the

Commission does not proceed wisely, the new rule could parallel the unfortunate effects of hasty repairs in other major industries in various stages of transition. Such unfortunate effects in the natural gas industry would be even more far reaching and serious -- because, as a practical matter, the consuming public has much more discretion in making a long distance phone call or taking an airline trip than it has in heating its home or running a business.

2. Would the NOPR create a regulatory system that would be operationally workable and legally sound?

As currently proposed, the NOPR could pose both serious operational problems and major grounds for legal challenge. However, if A.G.A.'s recommendations for change are adopted by the Commission, both the operational problems and the legal question marks can be significantly improved.

3. Would the NOPR create a regulatory system that would assure residential, commercial and industrial customers a reliable long-term supply at the lowest possible cost?

4. What impact would the regulatory system the NOPR proposes to create have on exploration for new gas supplies, and production from existing gas reserves?

The basic gas supply outlook is excellent for both the short term and the long term. So long as market forces are not distorted by reimposed wellhead price controls or indefinite continuation of Federally mandated gas use restrictions at the burner tip, the market can draw upon a gas resource base that is more than ample enough to handle contingencies. The key condition, however, is that the Federal Government must keep the wellhead and the burner tip free from artificial distortions. Thus, gas supply availability is in less danger from the NOPR than from the continuing Congressional reluctance to repeal the Fuel Use Act and incremental pricing. These statutes continue to strike directly at the efficiency of marketplace mechanisms, artifically depressing demand and therefore artificially depressing the "demand pull" effect that is a significant factor at the wellhead.

To reiterate our earlier discussion of the NOPR's supply impact, we believe that the NOPR would tend to generate both negative and positive impacts on producers at the wellhead. Negative effects on the producer would include a possible suspension of pipeline field purchasing activities and declining revenues for some producers in the wake of declines in the average wellhead price. Positive effects on the producer would include higher spot market prices (induced by increased carriage) and higher average "takes" due to higher overall gas demand.

We cannot quantify either the negative or the positive supply impacts, but the two trends would tend to neutralize each other -- leaving overall supply availability largely unaffected.

As noted earlier, however, we do have some concerns about the possible impact of the NOPR, as now proposed, "downstream" from the wellhead. Even temporary pipeline suspensions of field purchases can force gas distributors into a greater direct purchaser role than they prefer. This development could in turn adversely affect the cost and/or reliability of distribution company service, particularly in the case of small distributors. However, as we also noted earlier, this problem can be eased or eliminated if the Commission adopts A.G.A.'s recommendations on block pricing, take-or-pay relief and ceiling rates for interruptible pipeline carriage.

We add that, while adoption of constructive changes could improve the current version of the NOPR considerably, there is only one ultimate answer to the major and abiding problem of take-or-pay liability. That ultimate solution is to sell more gas. This Committee can play a leading role in accomplishing that goal -- namely, by initiating action to repeal the Fuel Use Act and incremental pricing. In our view, this is a compelling legislative priority, which should be acted upon promptly.

CONCLUSION

Thank you for this opportunity to present A.G.A.'s views on the gas supply impact of a landmark regulatory proceeding. I will be pleased to respond to whatever questions you may have.

ANALYSIS OF HIGH COST GAS PURCHASES BY CONTRACT TERMINATION DATE

Prepared for:

POLICY EVALUATION AND ANALYSIS GROUP
THE AMERICAN GAS ASSOCIATION

Prepared By:

FOSTER ASSOCIATES, INC.
Washington, D.C.

August 1985

ANALYSIS OF HIGH COST GAS PURCHASES BY CONTRACT TERMINATION DATE

INTRODUCTION

Foster Associates, Inc. has prepared this report on behalf of the American Gas Association.* The purposes of the report are: (1) to identify current high cost gas transactions (e.g., those without market responsive pricing provisions within the gas purchase contract) and (2) to determine the contract termination dates of these transactions. No attempt was made to estimate the level of reserves behind these high cost gas purchases, nor the projected volumes that would be expected upon contract termination date. This analysis focuses solely on current purchases of NGPA Sections 102 and 107 interstate gas, with contract dates prior to January 1, 1982.

SOURCES OF DATA AND METHOD OF ANALYSIS

Foster Associates' Online PGA Data Retrieval Service is a computerized database providing access to currently effective Purchased Gas Adjustment (PGA) filings by the major interstate pipelines with FERC. This database is the primary source of information for this report. Table 1 on the following page lists the pipelines currently in the database, the effective date of their PGAs and the dates of the actual and projected gas volume and cost information in the filing. These pipelines, in the composite, purchase approximately 9.2 Tcf of U.S. field production, representing the vast majority of purchases in the interstate market, and 54 percent of the total U.S. natural gas production. This database includes all of the pertinent information required to complete this study (e.g., contract date, NGPA category, producing area,

---

* William G. Foster and Rebecca Reddick were responsible for the preparation of this study.

August 1985

Table 1

PIPELINE PGA DATES AND DOCKETS
CURRENTLY IN ONLINE PGA DATA RETRIEVAL SERVICE

Pipeline Name	Effective Date	TA Docket No.	Actual Data	Projected Data
ANR Pipeline Co.	05/01/85	85-2-48	12 mos. ended 01/31/85	12 mos. beginning 05/01/85
Arkla Energy Resources	04/01/85	85-2-31	6 mos. ended 12/31/84	6 mos. beginning 04/01/85
Colorado Interstate Gas Co.	10/01/84	85-1-32	12 mos. ended 12/31/83	12 mos. beginning 10/01/84
Columbia Gas Transmission Corp.	03/01/85	85-1-21	6 mos. ended 08/31/84	6 mos. beginning 03/01/85
Consolidated Gas Transmission Corp.	03/01/85	85-1-22	6 mos. ended 10/31/84	6 mos. beginning 03/01/85
El Paso Natural Gas Co.	04/01/85	85-2-23	6 mos. ended 12/31/84	6 mos. beginning 04/01/85
Florida Gas Transmission Co.[e]	04/01/85	85-3-34	6 mos. ended 12/31/84	6 mos. beginning 04/01/85
KN Energy, Inc.	12/01/84[a]	85-1-53	12 mos. ended 05/31/84	12 mos. beginning 12/01/84
Mississippi River Transmission Corp.	03/01/85	85-2-25	12 mos. ended 12/31/84	12 mos. beginning 05/01/85
Mountain Fuel Resources	06/01/85	85-2-55	12 mos. ended 01/31/85[c]	12 mos. beginning 06/01/85
Natural Gas Pipeline Co. of America	03/01/85	85-1-26	6 mos. ended 10/31/84[b]	6 mos. beginning 03/01/85
Northern Natural Gas Co.[e]	01/01/85	85-3-59	12 mos. ended 07/31/84	12 mos. beginning 01/01/85
Northwest Central Pipeline Co.	4/23/85	85-2-43	6 mos. ended 01/22/85	6 mos. beginning 04/23/85
Northwest Pipeline Corp.	04/01/85	85-3-37	12 mos. ended 12/31/84	12 mos. beginning 04/01/85
Panhandle Eastern Pipe Line Co.	03/01/85	84-1-28	6 mos. ended 11/30/84	6 mos. beginning 03/01/85
Sea Robin Pipeline Co.	07/01/85	85-2-6	6 mos. ended 03/31/85	6 mos. beginning 07/01/85
Southern Natural Gas Co.	10/01/84	85-1-7	6 mos. ended 06/30/84	6 mos. beginning 10/01/84
Tennessee Gas Pipeline Co.	07/01/85	85-2-9	6 mos. ended 02/28/85	6 mos. beginning 07/01/85
Texas Eastern Transmission Corp.	07/01/85	85-3-17	12 mos. ended 03/31/85	12 mos. beginning 07/01/851[d]
Texas Gas Transmission Corp.	02/01/85	85-1-18	6 mos. ended 09/30/84	6 mos. beginning 02/01/85
Transcontinental Gas Pipe Line Corp.	05/01/85	85-2-29	6 mos. ended 10/31/84	6 mos. beginning 05/01/85
Transwestern Pipeline Co.	04/01/85	85-2-42	12 mos. ended 11/30/84	12 mos. beginning 04/01/85
Trunkline Gas Co.	09/01/84	84-1-30	12 mos. ended 05/31/84	12 mos. beginning 09/01/84
United Gas Pipe Line Co.	07/01/85	85-2-11	6 mos. ended 03/31/85	6 mos. beginning 07/01/85

a/ Not yet available.

b/ Data reported by Company on 12-month basis; converted to 6-month data by Foster Associates to conform with projected data.

c/ Data reported by Company on 5-month basis; converted to 12-month data by Foster Associates to conform with projected data.

d/ Data reported by company on a 7-month basis; converted to 12-month data by Foster Associates to conform with projected data.

e/ Revised PGA filing.

volume and prices) except for the individual contract terms. Contract terms have been independently researched for a sample of the transactions.

The steps taken in the preparation of this study are:

1. Access the Online PGA Data Retrieval Service to identify gas purchase transactions meeting the following criteria:

   - NGPA Sections 102 and 107 purchases, with
   - Contract dates prior to January 1, 1982, and
   - Projected prices greater than $3.80 per MMBtu.

   The $3.80 per MMBtu price was chosen to represent the minimum price of transactions under contracts without market responsive provisions (e.g., no market-out or economic clauses). The current NGPA Section 102 ceiling price, adjusted downward for Btu content, is the basis of the $3.80 per MMBtu.

   In total, 1.6 Tcf of annual gas purchases fall under the specified criteria; the current average price of these gas purchases is $4.49 per MMBtu. These purchases represent 17 percent of the major interstate pipelines' total domestic purchases, and 15 percent of the pipeline's total purchases (i.e., including imports, but excluding interpipeline transactions).

2. A sample of large volume transactions (i.e., greater than 200 MMcf per year) was chosen from all high cost gas purchases for the purpose of identifying their contract terms. Contract studies

available at Foster Associates and other available contract information were used as the source of this term information. In total, about 300 contracts were used for the sample, including a large number of available OCS contracts.[1] The sample represented about 27 percent of the total high cost gas purchases falling under the specified criteria.

3. The high cost gas purchases were arrayed by contract date (pre-1965, and for each year 1965 through 1981), and by producing area (OCS, Onshore Louisiana, Onshore Texas and other areas).

4. The sample of high cost gas purchases was then arrayed by the same criteria as stated above for all transactions (see No. 3), plus contract termination dates.

5. The contract termination dates of the sample were applied to the high gas cost purchases for the corresponding contract dates and producing areas, to determine the distribution of all high cost gas by contract termination date.

It should be emphasized that the high cost gas volumes reported here represent current gas purchases, and are not projected volumes upon contract termination date. The projected volumes of high cost gas upon contract termination date could be higher or lower. Factors understating these volumes include current "shut-in" volumes, the exclusion of intrastate purchases and the possibility of additional high cost gas coming on-line under pre-January 1, 1982 contracts. On the other hand, the volume would be lowered over time by applying an expected production decline curve. This is particularly important in the case of high cost gas because of the large proportion of this gas that is being produced in the OCS (i.e.,52 percent), where the decline curve is generally higher than the onshore areas.

---

[1] Transactions dealing with OCS gas represent 52 percent of the total high cost gas purchases.

RESULTS

About 38 percent of the total interstate gas purchased is NGPA Sections 102 or 107 gas. These categories of gas are some of the highest priced sources in the U.S.; for example, the average price of all Section 102 and Section 107 interstate gas purchases is $3.78 per MMBtu, compared with an average price of all field purchases at $2.64 per MMBtu.

There is a striking dichotomy of gas purchases by contract date governing the Section 102 and Section 107 purchase categories. This contractual dichotomy is between purchases with market sensitive pricing provisions vis-a-vis purchases at a much higher non-market sensitive price.

Table 2 shows a summary of these purchases by market sensitivity and by contract date (pre and post-January 1, 1982). In total, approximately 52 percent of all interstate Sections 102 and 107 gas purchases fall under the non-market sensitive category, with an average field price of $4.49 per MMBtu. Almost 90 percent of this gas was contracted for prior to January 1, 1982. The primary reason for this occurrence is the fact that market out and/or economic clauses are only evident in provisions of gas contracts executed after that date.

Table 2

SUMMARY OF NGPA SECTIONS 102 AND 107
INTERSTATE PIPELINE GAS PURCHASES
(Mid 1985)

	Volume (12 Months) (MMcf)	Price ($/MMBtu)
Pre Jan. 1, 1982 Contracts		
Market Sensitive	713,302	3.12
Non-market Sensitive	1,561,895	4.49
Total	2,275,197	4.05
Post Jan. 1, 1982 Contracts		
Market Sensitive	963,494	2.95
Non-market Sensitive	233,404	4.50
Total	1,196,898	3.26
Total		
Market Sensitive	1,676,796	3.02
Non-market Sensitive	1,795,299	4.49
TOTAL	3,472,095	3.78

Source: Foster Associates' Online PGA Data Retrieval Service

A primary purpose of this report is to determine the contract termination date of the current high cost (non-market sensitive) gas purchases.[1] To do so, it is useful to segregate these purchase volumes by contract date and producing area. Table 3 shows this distribution, and Chart 1 presents cumulative purchases by contract year.

---

[1] For contracts executed prior to January 1, 1982.

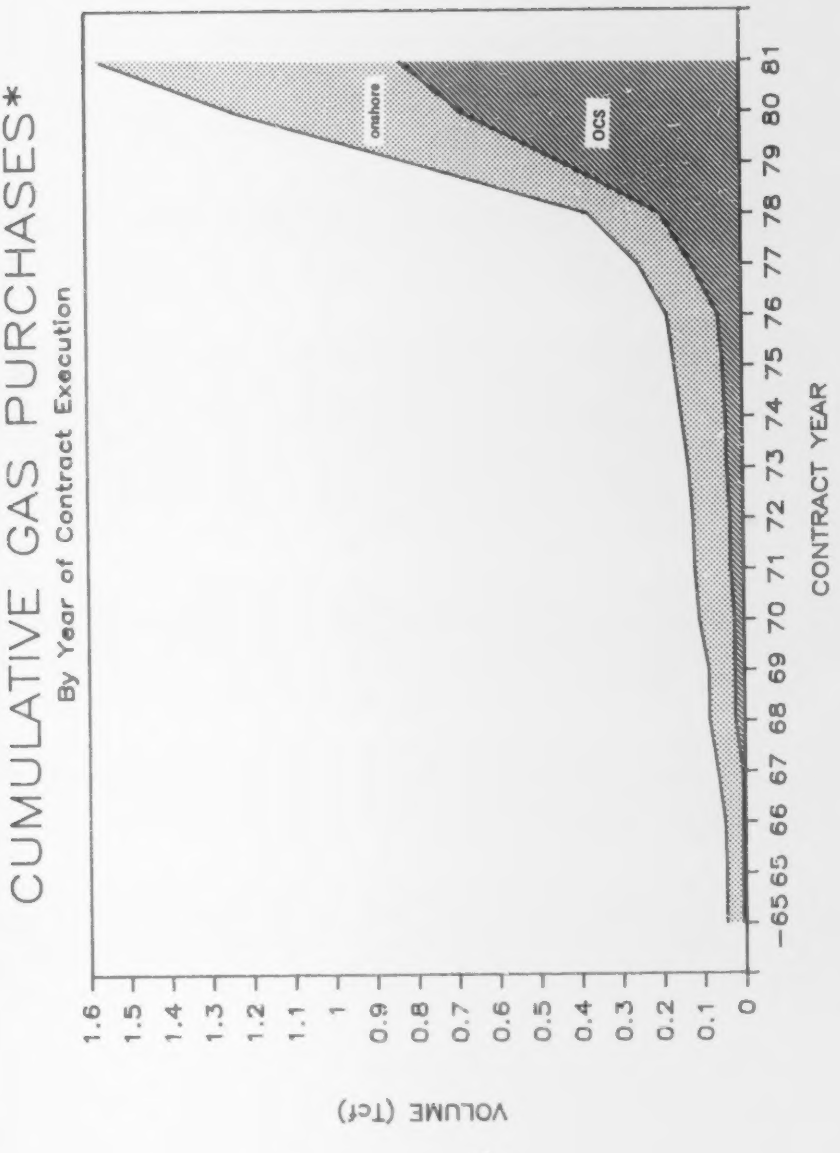
Table 3

HIGH COST GAS PURCHASES BY YEAR OF CONTRACT
AND PRODUCING AREA
(12 Month Volumes - MMcf)

Contract Year	OCS	LA Onshore	Texas Onshore	Other	Total
Pre 1965	6,716	17,806	13,120	8,278	45,920
1965	--	1,874	--	48	1,922
1966	--	--	1,406	1,562	2,968
1967	66	11,246	3,905	1,562	16,779
1968	17,649	54	--	1,718	19,421
1969	--	--	142	937	1,079
1970	4,217	214	--	18,118	22,549
1971	8,278	--	--	1,250	9,528
1972	312	--	1,093	2,343	3,748
1973	9,840	--	469	2,343	12,652
1974	2,343	1,874	106	16,556	20,879
1975	6,716	1,406	3,749	5,467	17,338
1976	9,528	5,935	469	1,093	17,025
1977	63,882	1,250	118	3,124	68,374
1978	75,440	4,998	12,808	29,051	122,297
1979	227,880	12,495	67,786	107,203	415,364
1980	228,034	28,938	22,120	121,975	401,067
1981	148,380	64,975	26,084	123,546	362,985
Total	809,281	153,065	153,375	446,174	1,561,895

Source: Foster Associates' Online PGA Data Retrieval Service.

Chart 1



*NGPA 102 and 107, high cost gas, and contracts executed before 1982

Several interesting facts are evident from these data:

1. About 52 percent of the high cost gas currently being purchased is produced on the Outer Continental Shelf (OCS) of Texas and Louisiana.[1]

2. Texas Onshore and Louisiana Onshore producing areas each represent about 10 percent of the total high cost gas production while other areas (e.g., Wyoming, Colorado, Oklahoma, and Kansas) represent 27 percent.

3. A large proportion of the current high cost gas is purchased from contracts executed since the passage of NGPA in 1978. The volume distribution by contract period is:
   pre-1970 - 7%
   1971-1978 - 17%
   post 1978 - 76%

   Long-term gas purchase contracts were the predominant type of contract during the pre-1982 period. Prior to 1960, many contracts were effective for life of the reserves, and since that time contracts generally run 15 to 20 years, with a smaller number effective between 5 and 10 years in more recent years. Most contracts for OCS gas have 15 to 20 year terms, and all NGPA Section 102(b) contracts for purchases from new OCS leases are at least 15 years long, following Section 315 of the NGPA, and FERC Order 20, issued 8/2/79 (RM79-8).

---

[1] About 25 percent of this OCS gas is classified as NGPA Section 102(b), production from new leases.

Because of the relative recentness of the contracts under which high cost gas is currently being purchased (i.e., since 1978), and the long term nature of these contracts, the majority of these high cost gas purchases will be effective until after 1990, as shown on Table 4 and depicted on the following chart. Only 13 percent of the high cost gas purchases are under contracts terminating prior to 1990, and 61 percent are under contracts terminating between 1990 and 1995, while the remainder (26 percent) terminate after 1995 or continue for life of the reserves. (Life contracts represent a relatively small share of the total, i.e., less than one percent).

Table 4

VOLUMES AND TERMINATION DATES OF HIGH COST GAS CONTRACTS (MMcf)

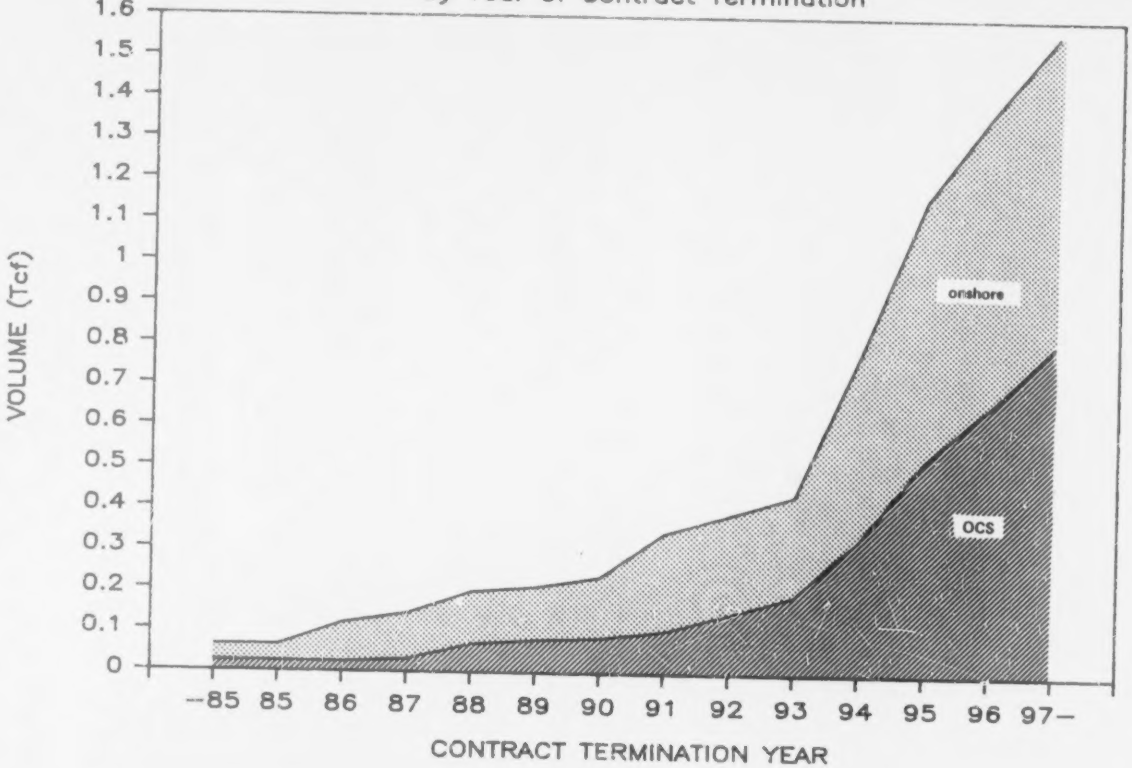
Contract Termination Date	OCS	LA	TX	Other	Total
Before 1985	24,002	17,806	13,120	8,278	63,206
1985	--	1,874	--	48	1,922
1986	1,239	16,244	6,521	30,886	54,890
1987	7,093	11,246	3,905	1,562	23,806
1988	37,586	1,653	4,099	11,014	54,352
1989	11,062	--	142	937	12,141
1990	6,497	214	--	18,118	24,829
1991	18,106	27,290	10,955	53,139	109,490
1992	41,835	--	1,093	2,343	45,271
1993	44,543	--	469	2,343	47,355
1994	139,071	14,369	67,892	123,759	345,091
1995	195,780	30,344	25,869	127,442	379,435
1996	130,520	27,377	9,077	41,863	208,837
After 1996 & Life	151,947	4,649	10,233	24,441	191,270
TOTAL	809,281	153,066	153,375	446,173	1,561,895

Source: Foster Associates, Inc.

Chart 2

CUMULATIVE GAS PURCHASES*

By Year of Contract Termination



*NGPA 102 and 107, high cost gas, and contracts executed before 1982

Senator NICKLES. Thank you very much.
Mr. Bunn.

STATEMENT OF RICHARD L. BUNN, SENIOR VICE PRESIDENT, UGI CORP., AND CHAIRMAN, ASSOCIATED GAS DISTRIBUTORS

Mr. BUNN. Good morning, Mr. Chairman. I am Richard Bunn, senior vice president of UGI Corp. and chairman of the Associated Gas Distributors, upon whose behalf I appear here today. AGD is an association of some 40 local distribution companies which provide gas utility service in the major market centers along the east coast. Our companies market about 25 percent of the gas sold in the interstate market and represents virtually all of the gas sold on the east coast.

I am pleased to be here to present AGD's views on the Federal Energy Regulatory Commission's notice of proposed rulemaking in its docket RM 85-1. In order to provide a full and complete presentation of our views, I have submitted with my statement copies of AGD's comments in that proceeding, as filed with FERC, and request that they be included in the subcommittee's record of this hearing.

I would like to respond to the four questions posed by the subcommittee. These questions are addressed in AGD's comments as filed with FERC, and, in one way or another, they involve most of the principal policy choices raised in the NOPR, the objectives of which, I should point out, AGD generally supports.

Turning to your questions—question 1, would the NOPR assure all consumers reliable, long-term gas supply at the lowest reasonable cost? The answer to this question depends to a great extent upon features of the NOPR which remain unclear. Having said that, let me suggest three areas of particular and serious concern to AGD.

First, there is a real danger that FERC may go too far too fast in encouraging the pipelines to forsake their historical role as the chief natural gas merchants. A sharp, radical and widespread withdrawal of the pipelines from their merchant function will unquestionably have repercussions for consumers at large, and these consequences would be costly for many. Caution should be the watchword here.

Second, the NOPR does not do enough to protect against pipeline bypass of gas distributors. Without further revisions, the NOPR would allow large industrial and commercial loads to be skimmed from distributors' markets with attendant adverse rate consequences to remaining, for example, residential, loads. Thus, one could argue that the NOPR tends to favor the large user who can take advantage of the new rules. FERC cannot close its eyes to these and other consequences of bypass on grounds that the Federal public interest stops at the State line.

Third, reliable gas supply generally presupposes an ability of gas utilities to supply and, thus, pipeline capacity once again becomes an important issue, if not the issue. The NOPR simply does not go far enough in assuring that existing firm pipeline customers will have the firm capacity, transportation or sales, necessary to meet the demands of their firm customers. Firm pipeline capacity on demand is a critical prerequisite to a gas distributor's ability to meet the continuing gas utility needs of all consumers at reliable prices.

Question 2, what impact would the NOPR have on gas exploration and production? Clearly, we are now, and have been for several years, working our way through a gas surplus which is symptomatic of a supply/demand imbalance. To the extent the NOPR creates a more efficient system for transmission of market signals, it should facilitate a move toward supply/demand equilibrium.

FERC should not, however, be driven exclusively by the engine of free market economic theory, especially in a setting where pipeline suppliers have monopoly power. Its charge under the law is broader and, thus, it has to take care to use its competitive tools adroitly both to achieve an economically efficient market and to protect the consumers from unjust or unreasonable prices. The public interest issues related to, for example, pipeline merchant function, distributor bypass and capacity allocation cannot be presumed resolved just because supply and demand are inbalance.

Question 3, would the NOPR system be operationally workable and legally sound? Unfortunately, the short answer to this question is that it remains to be seen. The system's workability turns on revisions yet to be made to it in several significant area.

For gas distributors there must be further clarification on numerous important matters related to the critical issue of pipeline capacity allocations, the availability of interruptible transportation service, pipeline market raiding or bypassing the local gas distributors, the nature and extent of take-or-pay relief, the specific rights or entitlements accompanying the proposed block pricing and, last but not least, the transition rules under which the change from the existing systems to the new NOPR rules would take place.

In other words, the NOPR system could be workable depending on the resolution of a host of yet unresolved and important components of it. Likewise, the legal soundness of the system cannot be accurately assessed until the particulars of it are better understood. Of course, it is fairly obvious that court challenges to any final rules will occur no matter what FERC does simply because of the breadth and contentious nature of the issues.

Question 4, would the public interest be better served by retaining the existing regulatory system? This is a very difficult question for the simple and straightforward reason that the existing system itself is fast-changing. Events were set in motion by Congress in 1978 in the Natural Gas Policy Act which are now bringing about more competition in the gas industry. We are surely in a transition period and whether it is FERC's NOPR in RM 85-1, an order from a Federal court, or a novel and imaginative proposal of a new entrant to the gas industry, the existing system is changing.

It is inherently dynamic. Thus, in a very tangible sense the ability to retain the existing system may well be irrelevant simply because of the real impracticality of doing so in light of these dynamics. About the only thing that is certain in this new gas industry is the fact that it is in a state of transition from an existing system to something else, and that some such transition is indeed necessary in light of market imperatives and legal requirements.

This completes my prepared remarks.

[The attachment to the prepared statement of Mr. Bunn follows:]

DEPARTMENT OF ENERGY
BEFORE THE
Federal Energy Regulatory Commission
WASHINGTON, D.C.

Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol	))	Docket No. RM85-1-000 (Parts A-D)

COMMENTS OF
ASSOCIATED GAS DISTRIBUTORS

July 15, 1985

Crowell & Moring
1100 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 452-5800

Dana C. Contratto
Roger B. Cooper
Lisanne M. Crowley
Herbert J. Martin
Frederick Moring

Attorneys for Associated
Gas Distributors

EXECUTIVE SUMMARY AND TABLE OF CONTENTS

Page

I. The AGD Companies 1

II. Introduction 2

III. AGD Comments On Specific Features Of The Proposed Rules 4

- A. The Pipeline Merchant Function Should Be Preserved 4
- B. Reasonable Safeguards Should Be Provided To Prevent Pipeline Market Raiding Or Bypassing Of LDCs 4
- C. A Reasonable System For Allocating Capacity Among Competing Shippers Should Be Provided In The Regulations 8
  - 1. Most east coast pipelines have little, if any, spare system-wide capacity during peak periods 8
  - 2. A system for allocating firm peak-day capacity should be provided in the regulations affecting the CD adjustment system 9
  - 3. LDC's entitlement to interruptible transportation service should be recognized 10
  - 4. The transportation system should recognize a priority for LDC interruptible service 12
  - 5. The pipeline zone system should be retained in conjunction with volumetric rates 13
- D. Orderly Transition To A More Competitive Natural Gas Marketing System 14
  - 1. LDC transportation service as a supplement to or substitute for firm gas purchases 14
  - 2. Optional expedited certificate proceedings 15

Page

3. Reporting requirements should be framed to correspond with actual pipeline ratemaking 17

4. Ratemaking standards and procedures 19

E. Take-Or-Pay 19

1. The NGPA Title I threshold issue may preclude some payments for nonrecoupable gas volumes 20

2. The prudence presumption should not apply to affiliate buy-outs 21

3. Buy-out costs should be spread over sales and transportation customers 21

4. Maximum safe harbor should be ten percent of the 1986-87 unrecoupable obligation per contract discounted to present value 22

5. Requiring all minimum payment or purchase obligations to be extinguished is unwise . 22

6. No producer's gas should be eligible for transportation service unless agreement has been reached on take-or-pay 23

7. All data relevant to a buy-out should be made available to pipeline customers upon request 24

F. Billing Procedure For Purchased Gas 24

1. Pipeline-to-pipeline domestic sales should be treated on an as-billed basis 25

2. The regulations should clarify the nature of a pipeline customer's entitlement to Block 1 gas 25

3. The prudence test should apply to pipelines' Block 1 purchasing practices 26

Page

4. Block 3 costs should be allocated where clearly assignable, with remainder spread proportionately over Blocks 1 and 2 26

5. Pipelines should be required to provide estimates of their expected annual Block 1 takes 26

6. Pipeline transportation service for non-pipeline shippers should not include Block 1 gas 27

G. General Procedure 27

IV. Conclusion 28

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Regulation of Natural Gas Pipelines) Docket No. RM85-1-000
After Partial Wellhead Decontrol) (Parts A-D)

COMMENTS OF ASSOCIATED GAS DISTRIBUTORS

In response to the May 30, 1985 Notice of Proposed Rulemaking, the gas distribution companies known as Associated Gas Distributors (AGD)[1/] submit the following comments on a joint and several basis. In addition, certain of these companies are submitting further comments individually.

I. The AGD Companies

The companies included in the AGD group are each local gas distribution companies (LDCs) which provide gas utility service in their respective franchise territories in states located along the east coast of the United States. Each of these companies acquires the major share of its natural gas supply from one or more of the large interstate gas pipelines regulated by this Commission.[2/] None of the AGD companies is an affiliate of any major interstate gas pipeline and none is an affiliate of a major gas producing company. Together, these companies provide service to some 11 million gas consumers, representing about 25 percent of the gas sales made annually through the nation's interstate gas system.

[1/] The names of the AGD companies are listed in Appendix A.

[2/] The major interstate pipeline companies which regularly supply gas directly to the AGD companies include, in alphabetical order, these companies: Algonquin Gas Transmission Company, Columbia Gas Transmission Corporation, Consolidated Gas Transmission Company, National Fuel Gas Supply Corporation, Southern Natural Gas Company, Tennessee Gas Pipeline Company, Texas Eastern Transmission Corporation and Transcontinental Gas Pipe Line Corporation.

II. Introduction

AGD has consistently recommended, both in this proceeding[1] and in others, that FERC exercise its regulatory jurisdiction to resolve the market disorder which has plagued the natural gas industry for several years. In the instant Notice, FERC has acknowledged both the existence of serious market disorders in the industry and the ineffectiveness of its existing scheme of gas pipeline/gas producer regulation in resolving that disorder. The Commission has promulgated a proposed new and comprehensive regulatory scheme intended to create a more orderly natural gas market. This goal is one AGD has previously affirmed as appropriate to current circumstances and which AGD continues to support in this proceeding. Further, AGD supports the

---

[1] AGD's Comments filed February 4, 1985 in this docket recommended the following five principles as the framework for Commission action in this proceeding:

1. Firm pipeline customers should have the right to elect to use a reasonable portion of the pipeline capacity devoted to their firm contracts as capacity available for use in providing firm transportation service to them.
2. The rate applicable to a pipeline's firm transportation service should be so structured or designed as to make the pipeline economically indifferent as to whether it sells or transports gas.
3. A pipeline should provide interruptible transportation service upon reasonable demand to the extent that capacity exists.
4. The rates applicable to pipeline interruptible transportation service should reflect reasonable differentials responsive to basic differences between on-system and off-system users of interruptible transportation service. To the maximum extent practicable, such rates should be so structured or designed as to make the pipeline economically indifferent as to whether it transports for or sells gas to an on-system or off-system customer.
5. The pipeline's priority of service as among interruptible transportation customers should give the highest priority to interruptible service rendered for the pipeline's firm resale customers.

Commission in its judgment that the forces of competition should play an important role in facilitating an end to market disorder. Properly managed and overseen by the legally responsible regulatory agency, gas industry competition can bring about major improvements in the industry's ability to achieve both reasonable prices for the nation's gas consumers and the necessary supply of natural gas to support continued utility operations in the long term future. In short, ACD supports both the Commission's goal in this proceeding and its principal strategy choice of allowing natural competitive forces to contribute to the resolution of many of the gas industry's complex economic problems.

With this support for the Commission's overall goal and strategy, AGD has chosen to confine its comments here to the specific means or techniques outlined in the Notice. In the transportation policy area (Parts I and III of the Commission's four part proposal as outlined at p. 53 of the Notice), AGD has four major concerns which are the basis for its comments. These concerns are (a) the need for adequate incentives to assure that interstate pipelines continue to perform their historical "merchant" function, (b) the need for safeguards to protect LDCs from discriminatory market raiding, (c) the absence of any significant ground rules in the Notice covering both the availability of pipeline firm and interruptible service to existing firm sales customers and the allocation of pipeline capacity among customers demanding interruptible service, and (d) the transition procedures whereby the comprehensive new transportation regulatory system would replace the status quo scheme. In addition, AGD's comments are directed to specific parts of the Notice relating to take-or-pay issues (Part II), to the billing procedures for purchased gas (Part IV) and to the need for informal consultation and collaboration with the Commission's staff before the final order here is becomes effective.

III. AGD Comments On Specific Features Of The Proposed Rules

A. The Pipeline Merchant Function Should Be Preserved.

The pipelines' traditional role of buying and selling gas (the so-called merchant function) is threatened by the instant proposal. The real-world impact of this proposal can only be measured after its terms have been placed into effect, of course. But the record ought to show that a substantial portion of the "interstate LDC industry" (AGD member companies) is concerned that this important role of the pipelines as a group has not been given appropriate attention in the design of the proposed new regulatory scheme for pipelines. Increased use of pipeline gas transportation service may be essential to achieve the benefits (primarily lower prices) of competition in this period of supply surplus. Nonetheless, the viability of the pipeline industry's gas acquisition programs is just as essential if those benefits are to be provided on a permanent basis. Pipeline gas acquisition efforts (a) have been undertaken for decades, giving pipeline companies a valuable body of knowledge and expertise, (b) are necessarily far more substantial, both in gas volume and geographic scope, than that realistically attainable by the largest LDCs or industrial end-users, and (c) offer the potential for economies of scale and diversity of contracting terms which will almost certainly be crucial to overall cost reduction in the era of wellhead gas price decontrol. For these reasons, the merchant function of the interstate pipelines should be maintained and encouraged as a working hypothesis for any new pipeline regulatory scheme.

B. Reasonable Safeguards Should Be Provided To Prevent Pipeline Market Raiding Or Bypassing Of LDCs

In fashioning the transportation policy to be promulgated here, the Commission cannot fail to note that the threat of a pipeline proposal "to bypass" an LDC and sell gas directly to an end-user historically served by an LDC is a reality in today's natural gas marketplace.[4] Bypass proposals[5] are incompatible with precedent established under the NGA and settled FERC regulatory policy; they should not be encouraged or supported by any new regulatory policy. There are two specific measures which should be adopted to assure that FERC's regulations do not encourage or promote LDC bypass proposals by pipelines.

First, the Commission should establish threshold requirements for applications involving bypass proposals, either by adding a special provision to its regulations governing all NGA Section 7 certificates (including optional, expedited certificates), by adding another "condition" to § 157.103 and § 284.223 or otherwise. The specific threshold requirement here recommended is that the applicant for Commission authority in a bypass proposal be required to demonstrate (a) that the state utility regulatory authority in the proposed gas-consuming locale has approved the bypass project and (b) that the franchised LDC is unable to provide adequate service.

The "state approval" requirement is reasonable under the circumstances. As the Commission knows, gas utility service rendered by most LDCs is fully regulated by state or local agencies. The state regulatory authority applicable to LDCs typically imposes an obligation to provide service to the general public within a specific geographic area and, likewise, frequently places restraints on the LDC's ability to withhold service, its policy on service terminations, its ratemaking practices, etc.

---

[4] See pipeline certificate applications pending at Dockets No. CP84-38 (ANR Pipeline Co.) and CP85-529 (Southern Natural Gas Co.). See also FERC order of June 19, 1985 at Docket No. CP84-393 (Panhandle Eastern Pipe Line Co.).

[5] For present purposes, the term "bypass proposal" refers to certificate applications by interstate pipelines in which authority is sought to construct and operate new facilities which interconnect an interstate pipeline and an end-user previously served by the LDC in the area. These new facilities may be used either to sell pipeline gas to the end-user or to provide transportation service to such user.

In short, the typical form of LDC state regulation is an expression of state policy or "state action" affecting the LDC's competitive position in the energy marketplace.

As indicated in the attached memorandum at Appendix B, the "state action" doctrine is an important part of federal antitrust policy. The policy underlying that doctrine justifies the threshold requirements here proposed.[8] The classic LDC bypass proposal represents a potential inroad or invasion of the local gas utility service system established by the state governments' actions and entitled to the respect of this Commission.

The other recommended threshold requirement is also reasonable. Even where a given state agency may approve a particular LDC bypass project, it is nonetheless important that this Commission be satisfied that the LDC is unable to provide adequate transportation or sales service to the end-user sought to be served by the bypassing pipeline. As the Commission knows, the interstate gas supply system has grown and prospered with pipelines selling gas primarily at wholesale and LDCs selling gas primarily at retail. The Commission has consistently favored LDC service as against direct pipeline service for end users.[9] To depart from this normative system, even where a state agency's approval has been given, represents a departure from *federal* policy established to protect the gas consumer. To authorize pipeline facilities which duplicate or parallel those of an LDC currently rendering service raises obvious public interest issues affecting other pipeline customers. Accordingly, there is a federal interest to be protected here, and a showing that the

---

[8] This recommendation is also consistent with the Commission's reference (at p. 26 of the instant Notice) to "federalism" and the discretion and authority of "State governmental authorities."

[9] *Missouri Edison Co. v. FPC*, 479 F.2d 1185 (D.C. Cir. 1973); *Panhandle Eastern Pipe Line Co. v. FPC*, 232 F.2d 467 (D.C. Cir.), *cert. denied*, 352 U.S. 891 (1956); *Panhandle Eastern Pipe Line Co.*, 36 FPC 1107 (1966); *Southern Natural Gas Co.*, 25 FPC 925 (1961).

LDC/incumbent supplier is unable to provide adequate service (either in the form of sales or transportation service to the end user) ought to be required before a bypass project will be certificated by this Commission.

Second, the Commission should apply appropriate ratemaking constraints to LDC bypass proposals. According to the Commission's ratemaking criteria in proposed Section 284.7, volumetric rates are required to reflect any material variation in the cost of providing service to "the geographic area in which the service is provided". Common sense suggests that the cost of transporting gas for, or selling gas to, an end-user should not be less than that for an LDC located in the same area. This proposition may be reflected in the above-quoted excerpt from Section 284.7. Nonetheless, the need for some more explicit ratemaking safeguard to protect LDCs against market raiding by pipelines is obvious. Recent experience shows that bypass is a "clear and present danger".[1] Accordingly, a specific provision denying pipelines the latitude to use their ratemaking discretion to facilitate LDC bypass or market raiding through geographic rate discrimination should be added, either as a separate element in the "rate conditions" of Section 284.7, by amending Section 284.223, by the addition of a provision to regulations implementing NGA Section 7, by all of these measures, or otherwise.

---

[1] The instant proposal is not intended to provide a "safe harbor" in which LDCs are exempt from competition and permitted to charge excessive rates to industrial customers for either sales or transportation service. Rather, this proposal is offered as one which recognizes that LDCs may soon be able to secure pipeline transportation service in greater and more assured quantities than before and that LDCs will be given new tools with which to compete effectively for industrial markets. Only where these tools break down or fail to bring about satisfactory arrangements between industrial gas consumers and LDCs should a bypass proposal be given this Commission's approval.

C. A Reasonable System For Allocating Capacity Among Competing Shippers Should Be Provided In The Regulations

The capacity allocation issue is important in resolving pipeline transportation policy. Apart from the brief reference to "curtailment procedures" at p. 30 of the Notice, the instant Proposal is silent on this issue. In this portion of these Comments, a recommendation is made on how the Commission should adopt policy guidelines governing the allocation of firm and interruptible sales and transportation capacity.

1. Most East Coast pipelines have little, if any, spare system-wide capacity during peak periods.

As a predicate for these comments, there is attached as Appendix C a factual presentation concerning the available system-wide capacity and existing service obligations of four east coast pipelines. The purpose of this Appendix is to show two important facts. First, on these pipelines there is only a small portion of uncommitted peak-day capacity in the northeast zones where demand is at its greates. The Commission must recognize that East Coast LDCs rely on this existing peak-day capacity for their heating load requirements. No system should be adopted which threatens the availability of this peak-day service. Second, there is no evidence that the market losses of any of these east coast pipelines in recent years have left them with significant peak-period spare capacity or that long-standing "bottle necks" have been eliminated. While there have been a variety of temporary market swings between east coast pipelines, the overall impact of these swings has been negligible in terms of allowing increases in firm capacity in the Northeast.

The significance of these two facts relates fundamentally to the policy prohibiting discrimination of any kind by pipelines engaging in transportation service. Unless the CD adjustment system "creates" spare peak day capacity, there is no reality, at least in some pipelines' service areas, to a system which purports to allocate peak-day capacity among "all shippers willing to pay" for firm service without discrimination, etc. Peak-day capacity of many pipelines has been preempted by firm, Commission-authorized contracts of these pipelines' customers so there is no significant "spare" capacity which can be used to support firm or peak-day service to others. This situation effectively pre-empts the right of any new customers to make new demands for firm or peak-day capacity on these pipelines in the zones where demand already exceeds available supply.

The fact that peak day service is "sold out" on many pipelines does not mean that pipelines lack the capacity needed to provide a significant level of transportation service. The point of the instant proceeding, among other things, is to adopt policy and procedures whereby the use of non-peak day capacity can be optimized to generate competitive benefits for all concerned.

2. A system for allocating firm peak-day capacity should be provided in the regulations affecting the CD adjustment system.

The firm, peak day requirements of LDCs are entitled to priority treatment as against other pipeline customers in any system which adjusts the firm sales obligations of a pipeline. This principle or ground rule should be made explicit in the regulations and should be applied in two situations described below.

According to the "CD adjustment" system outlined in § 157.21, firm sales customers may elect to reduce the daily volume of sales gas to which they are entitled. A crucial omission in this section of the proposed regulations should be recognized, i.e., the CD adjustment decision by an LDC should be provided in conjunction with a right to acquire firm transportation service. To the extent a CD reduction decision is matched by a decision to acquire an equal volume of firm transportation service, the firm service priority rights of the LDC to pipeline capacity should not be adjusted. This "even exchange" (where firm purchase rights are "exchanged" for an equal volume of firm transportation rights) situation should not place in jeopardy the LDC's priority entitlement to "its share" of the pipeline's peak-day capacity.

The regulations covering the CD adjustment system (*e.g.* § 157.21) should be amended to make this priority explicit.

Second, the LDC's service priority rights should also extend to the situation in which a CD reduction is not matched by a decision to receive an equal volume of firm transportation service. For example, if an LDC reduces its firm purchase rights by 100 Mcf per day, and elects to receive only 75 Mcf per day in firm transportation service, the 25 Mcf per day of capacity "left behind" should be made available to the other LDCs which need the peak-day capacity to support their utility service obligation.

The service rendered by LDCs is an essential gas utility service to the public in its franchise territory. Crucial to that service is the availability of *firm capacity* from the LDC's pipeline supplier, a commodity which is in generally short supply. To provide a reasonable measure of firm service protection to the gas consumer, it is important that any firm, peak-day capacity left vacant by one LDC be made available first to other LDCs. This priority right should therefore be made an explicit standard governing the disposition of firm peak-day pipeline capacity in the regulations covering the CD adjustment system (§ 157.21).

3. LDCs' entitlement to interruptible transportation service should be recognized.

A gross omission in the instant Notice is its silence on the delivery by pipelines of interruptible transportation service to LDCs. Given the Commission's stated intention to provide "an appropriate framework in which transportation may take place," and given the mandate of the recent Maryland People's Counsel cases,[9] the failure to address the subject of interruptible or off-peak transportation for LDCs is particularly serious. That failure should be remedied by amending the regulations as here recommended.

---

[9] The Commission's orders promulgating interruptible transportation service policy for pipelines were vacated in *Maryland People's Counsel v. F.E.R.C.*, ___ F.2d ___ (D.C. Cir, Nos. 84-1019 and 84-1090, May 10, 1985). The fatal flaw in these FERC orders was that "they allow transportation of direct-sale gas to fuel-switchable end users *without requiring pipelines to furnish the same service to*

(Footnote continued)

The instant Notice sets forth a "firm transportation requirement" in not less than five different regulations (see Notice, pp. 133, 141, 146, 159 and 170). Each of these proposed regulations also contains a provision indicating the pipeline "may also offer interruptible transportation service." This approach to the interruptible transportation issue will not do. The regulations should specifically require pipelines choosing to render any transportation service to offer interruptible transportation service at least to LDCs.

As indicated above, there is virtually no firm, peaking capacity available on some pipelines. The mandate to provide firm transportation service therefore is not meaningful in the case of these pipelines except where an existing sales customer chooses to adjust firm purchases and has not replaced such purchases with firm transportation service. Interruptible transportation service, on the other hand, is a crucial concern to LDCs. As the Commission knows, many LDCs have not been "eligible" to receive transportation service for discount-priced gas until the recent adoption of a "10 percent of firm contract entitlement" rule.[10] The heart of the transportation scheme in which gas vs. gas competition will provide consumer economic benefits is the delivery of interruptible transportation service to LDCs in greater quantities. The right of an LDC to acquire gas at cheaper prices will enable LDCs to compete, not only with other energy forms but also with others selling natural gas. It follows that the important mandate is that for interruptible service to those to

---

[9] (continued)
LDCs and captive consumers on nondiscriminatory terms." (slip opinion, No. 84-1090, p. 20 footnote omitted, emphasis added).

[10] See Tenneco Oil Company et al, 28 FERC ¶ 61,383 (1984).

which it has been largely denied in the past -- the LDCs. For these reasons, the Commission should replace the permissive language on interruptible transportation service with a mandate for such service to LDCs.

4. The transportation system should recognize a priority for LDC interruptible service.

Leaving aside the problems of firm or peak period service needs, there is a need to build into any comprehensive scheme of gas transportation a mechanism whereby the LDCs' priority of service can be recognized in the allocation of off-peak capacity. This point is relevant when the interruptible off-peak demands of LDCs and those of others exceed the available pipeline capacity so that some method of capacity allocation is required. Such a system of off-peak pipeline capacity allocation has not been the subject of regulation to date by the Commission (it has instead been informally administered by the pipelines). The need is imperative, however, for such a system in the future as off-peak volumes increase, as the industry seeks to deplete its surplus and the new "non-discrimination policy" takes on day-to-day meaning to pipelines, LDCs and shippers generally.

The economic rationale for a system in which the LDCs' demands for off-peak pipeline capacity are given first priority is provided in Exhibit A, which contains the prepared testimony of economist Louis A. Guth. As there explained, the grant of a service priority to LDC demands is preferable to other systems whereby limited pipeline capacity might be allocated among customers seeking access to this capacity.

The purpose of an LDC priority to interruptible transportation capacity is not to equip LDCs with an unfair advantage over other potential shippers. The purpose is to provide LDCs with real incentives to make use of off-peak transportation capacity to acquire gas supply at competitive prices, thereby serving the needs of the general public in their franchise areas and thus realizing the Commission's goal in this proceeding. As a key constituent in the interstate gas supply system,[11] LDCs should be recognized as an indispensable component in the more competitive pipeline regulatory system here being established. LDCs are in the strategic position of delivering the economic benefits of the system to all consumers in their service areas. They should be given appropriate incentives to perform this function so that the new system will achieve its intended goal.

As a corollary to the foregoing discussion, the Commission should recognize that its new regulations would remove Section 157.209 from the prior regulations. Among the provisions removed would be that which requires that a transportation contract between an end-user and a pipeline provide that service is conditioned upon

> "the availability of capacity sufficient to provide the service without detriment or disadvantage to the certificate holder's [pipeline's] existing customers who are dependent upon the certificate holder's general system supply."

Mere deletion of this contract language requirement from the regulations has no significant impact on the legal rights of existing customers to adequate service.[12] On the other hand, this proposed change points to the need for a specific Commission policy responding to the interruptible capacity allocation issue. That policy, as recommended here, is one in which the priority of LDC interruptible services is specifically recognized.

5. The pipeline zone system should be retained in conjunction with volumetric rates.

The advent of volumetric rates with ranges of just and reasonable rates raises a series of questions. One of these is whether traditional pipeline rate zones should continue to be used as a basis for alleviating or reducing rate discrimination between customers located in the same general geographic location.

---

[11] Among the factors distinguishing LDCs from others in the industry is that they are the pipelines' firm customers and, as such, typically pay the majority of the fixed charges associated with pipeline operations.

[12] See Granite City Steel Co. v. F.P.C. 320 F.2d 711 (D.C. Cir. 1963).

The recommendation here is that rate zones should continue to be honored, that pipelines should not be permitted to adopt a practice whereby customers within a single rate zone pay different rates for substantially the same or identical service. To proceed otherwise would lead to chaos. Pipelines would be inclined to segment their wholesale markets ad infinitum, and the opportunity for controversy regarding due and undue discrimination would be enormous. While the proposed regulations are now largely silent on the effect on pipeline rate zones, they should not be. The principle of intrazone rate parity for similar or identical services should be incorporated at an appropriate place, possibly as a standard condition to any certificate issued to authorize initial service under the one-part rates outlined in Section 284.7 or otherwise.

D. Orderly Transition To A More Competitive Natural Gas Marketing System

The transition process, i.e. the move from status quo regulations to a scheme generally along the lines of that proposed in the Notice, is an important and crucial phase of this rulemaking proceeding. The legal and practical challenges of "changing the rules while the game is being played" are substantial. The discussion here is intended to identify some of the potential problem areas and to suggest some reasonable solutions.

1. LDC transportation service as a supplement to or substitute for firm gas purchases.

In its earlier comments herein, AGD advocated the principle that firm transportation be available upon demand to any firm pipeline customer for a reasonable portion of the pipeline capacity devoted to that firm customer. In discussing the "reasonable portion" of capacity that should be provided, AGD suggested (without a specific recommendation) that an amount in the range of 25 percent would be reasonable. The important point here, of course, is the need simultaneously (a) to preserve the pipeline's merchant function and (b) to remove any disincentives for the pipeline to offer transportation service to its firm customers.

The instant Notice contains an important feature which is apparently responsive to AGD's and others' earlier recommendation. That feature (found at pp. 162 _et seq_. of the Notice) provides for a "condition" in the Commission's regulations governing the issuance of NGA Section 7 certificates to interstate pipelines. By its terms, this condition provides

> "any firm sales customer of an interstate pipeline . . . may reduce the contract demand in its firm sales service agreement . . . if the pipeline after the effective date of this rule . . . accepts a certificate issued pursuant to Section 7 of the Natural Gas Act . . . ." (p. 163, Notice)

While this condition is of obvious importance to LDCs and is supported by AGD, it does not go far enough. The primary missing ingredient in the § 157.21 CD adjustment process is the LDC's right to acquire firm transportation service in an amount equivalent to its reduction in its level of firm purchases. That right should be prescribed in any new regulation which authorizes an adjustment in a firm customer's purchase obligation.

2. _Optional expedited certificate proceedings_.

Section 157.102(a) (p. 166) of this Notice prescribes the "contents of [an optional certificate] application". This section may be important in the transition certificate process (depending on the pipelines' elections) and should be supplemented with that contingency in mind. The specific additions here recommended include (a) an explanation of how the applicant intends to interpret the "non-discriminatory access" provisions of Section 157.103(f) (p. 170) of the Regulations, with particular reference to the availability of firm transportation service to both customers previously authorized to receive firm sales service and those not previously receiving firm sales service, (b) the policy to be observed in allocating available transportation capacity among those demanding interruptible transportation service, and (c) where the application proposes pipeline service to an end-user previously receiving service from an LDC, a showing should be required that the appropriate state regulatory authority has approved the proposed service and a showing that the LDC in question is unable to provide adequate service to the end-user.

Section 157.104(b) (p. 177) of the Regulations contains a "presumption" that the NGA Section 7(e) standards (including the public convenience and necessity test) have been satisfied. As an element of § 157.104(b), the proposed text indicates that a certificate applicant which complies with § 157.102 (relating to contents of the application) and § 157.103 (relating to the standard terms and conditions such as non-discriminatory access, etc.) has demonstrated its "willingness to assume all economic risks of the proposed activities". This proposition is of doubtful validity in at least some of the settings to which optional certificate procedures may be applied. If, for example, a firm sales customer is afforded the option of acquiring increased transportation service under the terms of the application, the "economic risks" inherent in such a transaction may include the risk that gas acquired through transportation service can be acquired at no higher cost than gas purchased through sales service. Obviously, the pipeline would not assume this risk. Therefore, the phrase "all economic risk of the proposed activities" is overbroad and unrealistic, at least in this example and in others which could be presented as reasonably within the contemplation of the proposals authorized by § 157.100. To the extent that the economic risk assumption is important to the presumption of public convenience and necessity etc. in § 157.104(b), this presumption would not and should not be applicable in a potentially large number of cases.

Moreover, where an intervenor or protestor has raised genuine issues of fact material to the Commission's determination, *i.e.* where such a party has complied with the rules, the presumption should disappear. Intervenors should not be deterred or discouraged from raising issues by the threat that they will be required to assume an evidentiary burden which, under applicable precedent,[11] is assigned either to the pipeline applicant or to the Commission's staff. Whether this presumption is ever applicable no doubt depends on the nature of the "new service" proposed by the applicant. Considering the broad range of new services contemplated by the Notice and potentially the subject of expedited applications, this presumption should probably be discarded. At most, it should be confined to routine, minor services. It should not be a generally applicable rule relieving the applicant of its burden to prove that its proposal for new service is in the public interest genuine real issues have been raised.

3. *Reporting requirements should be framed to correspond with actual pipeline ratemaking.*

A pipeline rendering service under the maximum - minimum rates authorized in proposed § 284.7 should be required to notify the Commission and its customers *promptly* whenever it changes the rate actually charged to its customers, even if the new rate is within the authorized rate range. This concept should be built into the reporting requirements of the proposed new rate *and* certificate regulations.

Section 157.207 of the Notice (p. 183) prescribes the reporting requirements applicable to holders of optional certificates. Other sections of the Notice (e.g. § 284.106 at p. 134) prescribe similar reporting requirements for pipelines providing various kinds of transportation services. Whether any adjustments in these requirements will be appropriate will depend on the nature of the new services authorized under these certificates.

---

[11] The Commission has an affirmative duty, in certain circumstances to identify and explore alternatives to certificate proposals presented to it. See *City of Pittsburgh v. F.P.C.*, 237 F.2d 741 (D.C. Cir. 1956)..

It is not unlikely that among the new services sought by pipelines will be service in which the pipeline proposes to initiate either transportation or sales service pursuant to the rate conditions of § 284.7. After all, the regulations require pipelines to "have on file" rates which comply with this section before certain new service can be authorized. If such a new service were initiated by an interstate pipeline, the appropriate reporting requirements in the regulations should be expanded. The initiation of service pursuant to the maximum and minimum rate conditions of § 284.7(b) would present the possibility that a pipeline would be simultaneously applying a different rate to different customers receiving the same service in the same rate zone.

While the indicated rate discrimination may or may not be contemplated by this Notice, the opportunity apparently provided for it under the indicated rate conditions raises the need for timely information reports to the Commission and the pipeline's customers. Data to disclose the ratemaking practices actually followed by pipelines rendering the authorized new service have important and obvious competitive significance. This significance is heightened by the broad "rate charging" discretion given the pipeline under § 284.7(c). Accordingly, the recommendation here is that a pipeline rendering service pursuant to the rate conditions of § 284.7 be required to notify the Commission and/or its customers promptly whenever it changes the rates actually charged its customers.

Depending on the frequency of any such changes, the necessary changes in the Notice provisions should be modified. A pipeline which changes its rates daily should be required to report changes to both the Commission and its customers on a daily basis. A pipeline changing rates less frequently should obviously not be required to make daily reports to the Commission and its customers. Without spelling out the possible permutations and combinations of reporting requirements reasonably needed, the point here is that the effective operation of competitive markets requires price discovery techniques different from those found in the reporting requirements of these rules. Accordingly, serious attention should be given to this problem before the new transportation and sales service contemplated by the Notice is elected and delivered by the pipelines.

4. Ratemaking standards and procedures.

In its formal presentation during phases II and III of the Notice of Inquiry in this proceeding, AGD recommended that the Commission exercise its rulemaking authority to bring about certain changes in the pipeline rate increase process. AGD continues to make this recommendation, even in light of the new scheme outlined in the instant Notice. There is attached as Appendix D an expended description of changes in the pipeline rate case process based on AGD's Phase II and III proposal. That recommendation should be adopted.

E. Take-Or-Pay

The Commission proposes here to encourage pipeline companies to "buy-out" of the "unrecoupable" take-or-pay obligations in certain "problem contracts" by providing a rebuttable presumption of prudence to attach to such "qualifying payments" (buy-outs) for purposes of recovering those payments in rates. The status of these payments under the NGPA Title I ceiling price standards is an unresolved issue which will presumably be resolved in other cases. That issue aside, given the traditional allocations of burdens of proof under the Natural Gas Act, the idea of a rebuttable presumption of prudence is a marked departure from the status quo, representing a significant benefit to pipeline companies. Thus, the Commission should approach this regulatory change with circumspection[14] and should provide both procedural and substantive restraints on the pipelines' exercise of the "safe harbor" option. By the same token, flexibility beyond that allowed appears appropriate on future take obligations and, overall, stronger incentives are necessary for producers to participate. These points are discussed below.

1. The NGPA Title I threshold issue may preclude some payments for nonrecoupable gas volumes.

Nonrecoupable take-or-pay payments present an important issue under NGPA Title I. Under the maximum lawful price provision of that Title, a producer/first-seller may not receive an amount for gas which, when divided by the volume delivered, yields a unit price in excess of that applicable to that gas.

The status of "buy-out payments" for nonrecoupable gas volumes under pipeline-producer sales agreements has not been finally resolved. This issue has been raised, however, in several proceedings now pending at FERC. Depending on how this issue is finally resolved, the procedures proposed in the instant Notice may or may not be seriously affected. If, for example, the receipt of funds for nonrecoupable gas volumes are finally held in particular circumstances to be in violation of the NGPA Title I ceiling prices, the safe-harbor presumption obviously could not apply to the "buy-out" of any such obligations. The pendency of this issue does not necessarily preclude the Commission from pursuing a policy based on the assumption that the receipt of take-or-pay payments for nonrecoupable gas volumes would be lawful. That issue should be noted, however, as a factor which may ultimately affect the procedure which may be adopted here, at least in certain situations. Certainly the Commission should frame any order in this proceeding to avoid any claims that the Title I issue has been decided here.

---

[14] The need for caution in adopting a take-or-pay buyout policy is heightened by the fact that the instant record contains no reliable data, much less substantial evidence, from which to estimate the take-or-pay dollar exposure amounts for which the "safe harbor" is proposed to be created.

2. The prudence presumption should not apply to affiliate buy-outs.

A safe harbor presumption of prudence should not apply to take-or-pay liability exposure buy-outs as between a pipeline and its production affiliate. These arrangements, to the extent they are made at all, should not receive any presumption of validity. Indeed, take-or-pay settlements between pipelines and their production affiliates ought to be subject to even stricter scrutiny than usual. At the very least, pipelines making such settlements should continue to carry the burden of proving their prudence in any rate proceeding where payments to affiliates are sought to be recovered.

3. Buy-out costs should be spread over sales and transportation customers.

Second, the proposed regulations provide that the method of recovering take-or-pay buy-outs and the apportionment of those costs among the pipeline's customers will be handled on a case-by-case basis in individual rate case filings. While the case-by-case approach is a generally sound procedure, the Commission should specifically direct that the costs of buy-out agreements be apportioned among all pipeline customers, sales as well as transportation. Practically all pipeline transportation customers have as much of a connection to the pipeline's incurrence of the buy-out costs as the pipeline's sales customers. Indeed, it is arguable that transportation service customers are more responsible (on direct causation grounds) than sales customers for the incurrence of take-or-pay costs. To the extent these costs are ultimately found prudent and rate recovery is allowed, they are clearly "system" costs to be borne by all system users -- sales and transportation alike. Any failure to allocate buy-out costs to the sales and transportation functions alike is bound to lead to uneconomic regulatory incentives for either sales or transportation. The principle of pipeline economic indifference would be unnecessarily compromised in such a situation. Thus, if recovered at all, the cost of take-or-pay buy-outs should be recovered from both sales and transportation customers.

4. Maximum safe harbor should be ten percent of the 1986-87 unrecoupable obligation per contract discounted to present value.

The Commission proposes to provide a "safe harbor" (rebuttable presumption of prudence) for some ("X or Y") percent of a pipeline's estimated 1986-87 unrecoupable obligation. Certainly the prudence of any particular pipeline's payment of any specific percent of its 1986-87 unrecoupable obligation will turn on the particular facts and circumstances attendant to that pipeline's behavior. Eight percent may be appropriate for one pipeline, but no percent may be prudent for another. In any event, there should be some maximum level, above which no buy-out will be presumed prudent. In light of the general terms of buy-outs that have occurred to date, the time-value of money over the short-run, the interests of all concerned in "getting the problem contracts behind us," the efficiencies of settlement over litigation, and the speculative nature of the buy-out cost, the maximum allowed percent should be no greater than ten and should be discounted to present value for the two years concerned.[15] This percent should be applied on a per contract basis so that no producer can receive more than the 10 percent maximum.

5. Requiring all minimum payment or purchase obligations to be extinguished is unwise.

The proposed regulations would require any "qualifying" payments" to extinguish all minimum payment or purchase obligations. This does not seem necessary or appropriate, recognizing that the effect of the safe harbor buy-out concept may be a complete renegotiation of the producer/pipeline contract. In such a renegotiation the pipeline should have the discretion to offer take assurances at some appropriate level in order, say, to achieve producer price concessions. In other words, take-or-pay provisions are not without some legitimate basis[18] in gas purchase contracts; the parties should be allowed the flexibility to renegotiate a buy-out of future take-or-pay liability exposure while retaining some reasonable level of take-or-pay commitment in the future. Essentially, the parties should be permitted to "buy-down" future take obligations as well as "buy-out" entirely of those obligations. As a reasonable restraint, however, no "buy-down" should be considered eligible for the prudence presumption unless the minimum purchase obligation is reduced to no greater than 50 percent of annual contract deliverability.

---

[15] The Commission should recognize that any percentage level chosen as the value of "x" or "y" will almost certainly create a floor for actual payments by pipelines.

6. No producer's gas should be eligible for transportation service unless agreement has been reached on take-or-pay.

It is clear that take-or-pay represents the single-most important problem in the gas industry today. Indeed, but for take-or-pay, it is questionable whether gas transportation service would be so prevalent. Yet, the proposed rules here do nothing to encourage producers to settle take-or-pay claims or renegotiate take-or-pay obligations with pipelines. Some avenues to potential money incentives via pipeline buy-outs are provided in terms of "carrots", but no "sticks" of any kind are put forth to encourage producers to come to terms with pipelines. This is a significant deficiency in the proposed rules which should be remedied. Given the comprehensive and cohesive nature of the Commission's proposed rules, one obvious and reasonable way to encourage producer participation and settlement of take-or-pay liabilities would be to fashion certificate conditions so as to deny access to transportation service to any producer which does not settle take-or-pay liabilities with its would-be pipeline transporter.

---

[18] As revenue-assuring provisions, such provisions offer an inducement to the exploration for and commitment of new natural gas supplies to market.

7. All data relevant to a buy-out should be made available to pipeline customers upon request.

For the most part, the implementation of the take-or-pay safe harbor buy-out lies in discretionary actions of the pipelines. The proposed regulations set forth some data requirements, but they are modest. Indeed, the availability of the rebuttable presumption is apparently not dependent upon any particular level or degree of explanation of an unrecoupable obligation, but arises merely from the fact of some explanation. If a rebuttable presumption of prudence is to arise as to a pipeline's qualifying payments, then a more substantial amount and degree of disclosure of the facts available to, and judgments made by, the pipeline is necessary. Sufficient data should be required to assure pipeline customers, who are directly affected by the rate implications of the buy-outs, of the reasonableness of the pipeline's actions. Further, any and all workpapers and other items upon which the pipeline relied in reaching specific settlements with producers should be available for review upon request of any affected pipeline customer. Without disclosure requirements such as these, the parties most affected by a pipeline's decisions are left with a vague regulatory formula, implemented solely by the pipeline as the initial arbiter of the reasonableness of the buy-out action and a less than adequate data base from which either to assess or challenge that action. This is not acceptable.

F. Billing Procedure For Purchased Gas

As to purchased gas costs, the Commission has proposed a three-part billing mechanism basically with "old" gas in Block 1, "new" gas in Block 2 and all other demand and commodity costs not included in 1 or 2 in Block 3. The proposal is fairly straightforward, but some aspects of it need clarification, and others may benefit from modification.

1. Pipeline-to-pipeline domestic sales should be treated on an as-billed basis.

While the proposed regulations appear to segregate Block 1 gas, for example, through pipeline-to-pipeline transactions in the marketing chain, this is not free from doubt. The regulations apparently require this treatment in the reference to direct and indirect purchases being segregated by blocks. Simply stated, the selling pipeline's domestic Block 1 gas should become Block 1 gas available for sale thereafter by the buying pipeline. This is a reasonable way to treat tandem pipeline domestic gas sales and should be explicitly set forth as such in the regulations.

2. The regulations should clarify the nature of a pipeline customer's entitlement to Block 1 gas.

The proposed regulations allocate a pipeline's Block 1 gas to its existing firm sales customers in proportions to those customers' firm purchases in 1982, 1983 and 1984. The nature of the customer's entitlement to Block 1 gas is, however, unclear in relation to the customer's overall gas supply options. For example, the Notice fails to make clear whether a pipeline customer can elect Block 1 volumes for a given future period or whether it is bound by the Block 1 and Block 2 "mix" which is experienced in a given period in a pipeline's purchase pattern. If the customer does not have the right to elect for Block 1 gas in a given period and to reject Block 2 gas during that period, the rules should so state. The importance and the competitive value of the 2-block dichotomy obviously hinges on whether the pipeline or its customers are allowed to control the mix of gas delivered during a particular future period. In the interest of equipping LDCs with the tools necessary to compete, pipelines should not be given the discretion to determine the Block 1 - Block 2 mix of their deliveries.

3. The prudence test should apply to pipelines' Block 1 purchasing practices.

Given the proposed "allocation" of Block 1 to firm sales customers and the fact that those customers could now find themselves in competition with their pipeline suppliers for industrial sales, it becomes all the more important that a pipeline's purchasing practices (i.e. its Block 1 take patterns) be subject to a prudence test. The draft regulations apparently assume pipeline purchasing practices "as usual" and that firm customers will somehow get their "entitlement" in the usual course of business. This is simply not a satisfactory way to assure that firm customers get their Block 1 percentage "entitlement." Accordingly, the regulations should insure a continuing prudence review of a pipeline's takes of Block 1 gas.

4. Block 3 costs should be allocated where clearly assignable, with remainder spread proportionately over Blocks 1 and 2.

Where the non-gas, Block 3 costs are clearly associated with, or can be clearly assigned to, Blocks 1 or 2, they should be so allocated. NGPA Section 110 charges should be handled in this manner. The remainder of Block 3 costs should be allocated proportionately over Blocks 1 and 2. Simply stated, cost responsibility should follow cost incurrence. If costs in Block 3 are clearly assignable to Blocks 1 or 2, they should be so allocated; where that assignability is not clear, they should be split proportionately. With this allocation of Block 3 costs, the proposed billing procedures would more accurately and efficiently transmit market signals. Further, pipeline sales into new markets would be particularly sensitive to market forces, and there would be little, if any, subsidy of new Block 2 markets by those who purchase from both Blocks 1 and 2.

5. Pipelines should be required to provide estimates of their expected annual Block 1 takes.

The proposed regulations require a pipeline to notify its customers on October 1, 1985 and annually thereafter of the estimated annual quantity of Block 1 gas which is "available" to the pipeline for sale in that year. The amount of Block 1 gas "available" for sale is not, however, a meaningful number, unless the pipeline actually expects to take that quantity. A more useful estimate would be the amount of Block 1 gas which the pipeline estimates it will take over the period in question. Without some reasonable estimate of this number, it would be difficult for firm sales customers to plan their gas supply options. The final regulations should be revised to require this projection by pipelines.

6. Pipeline transportation service for non-pipeline shippers should not include Block 1 gas.

According to the Proposal's new PGA system, a pipeline's "Block 1" gas supply is dedicated for use by that pipeline's firm sales customers (according to their purchases during the 1982-84 base period). This policy is apparently (and perhaps inadvertently) in conflict with the terms of Section 284.223(a)(1), which allows a pipeline to "transport any natural gas for any shipper . . . ." (Emphasis added.)

The terms of Section 284.223 are obviously intended to facilitate transportation service on a blanket or semi-automatic basis. The text at p. 78 of the Notice suggests that this transportation authority will be issued in conjunction with producer and/or pipeline abandonment and pipeline certificate orders. As presently drafted, the automatic authority issued under Section 284.223 could be interpreted to cover the abandonment (or release) of Block 1 gas supply under dedication or commitment to a pipeline. Since such gas has been reserved for the pipeline's historical customers, the gas supply eligible for transportation under § 284.223 should be limited to gas other than that classified as Block 1 gas supply, i.e. Block 2 gas supply.

G. General Procedure

For a variety of reasons, the schedule of this proceeding has been expedited to the point where a minimum of time has been available for the preparation of these comments. The Commission should recognize this fact in scheduling its next steps in this proceeding. For example, if the Commission next adopts a new rule with a specific effective date, it should schedule sufficient informal conferences with its staff so that interested parties can gain a better understanding of whatever system is prescribed in the new rule before it becomes effective. The transition phase, whatever its schedule and precise contents, is obviously crucial to the success of whatever new gas transportation system and policy the commission adopts. Industry understanding, not widespread confusion, is what the commission must have if its effort here is to achieve the kind of changes contemplated in the Notice. Accordingly, whatever informal procedures can be provided to enhance understanding should be arranged.

IV. Conclusion

AGD recommends that the several changes outlined here be adopted in issuing any final rule in this proceeding.

Respectfully submitted

Associated Gas Distributors

By Frederick Moring
Frederick Moring

CROWELL & MORING
1100 Connecticut Avenue, N.W.
Washington, D.C. 20036
452-5800

Dana Contratto
Roger B. Cooper
M. Lisanne Crowley
Herbert J. Martin
Frederick Moring

July 15, 1985

Attorneys for Associated Gas Distributors

APPENDIX A

MEMBERS OF ASSOCIATED GAS DISTRIBUTORS

Atlanta Gas Light Co.
Baltimore Gas & Electric Co.
Bay State Gas Co.
The Berkshire Gas Co.
Boston Gas Co.
The Brooklyn Union Gas Co.
Central Hudson Gas & Electric Corp.
Chesapeake Utilities Corp.
City of Holyoke, Mass., Gas & Electric Dept.
City of Norwich, Dept. of Public Utilities
City of Westfield Gas & Electric Light Dept.
Colonial Gas Co.
Commonwealth Gas Co.
Concord Natural Gas Corp.
Consolidated Edison Company of New York, Inc.
Delmarva Power & Light Co.
Elizabethtown Gas Co.
EnergyNorth, Inc.
Essex County Gas Co.
Fitchburg Gas & Electric Light Co.
Lynchburg Gas Co.
New Jersey Natural Gas Co.
New York State Electric & Gas Corp.
North Carolina Natural Gas Corp.
Northeast Georgia Municipal Gas Utilities
Northeast Utilities
Northern Utilities, Inc.
Pennsylvania Gas & Water Co.
Pequot Gas Co.
Philadelphia Electric Co.
Philadelphia Gas Works
Providence Gas Co.
Public Service Company of North Carolina, Inc.
Public Service Electric & Gas Co.
South County Gas Co.
South Jersey Gas Co.
The Southern Connecticut Gas Co.
UGI Corporation
Valley Gas Co.
Washington Gas Light Co.

Appendix B

Memorandum of Law On The Antitrust Law State Action Exemption and its Application to State-Regulated Public Utilities

As the D.C. Circuit Court of Appeals noted recently, "[a]ntitrust policy surely is a factor relevant to responsible administration of the 'public convenience and necessity' standard under Section 7 of the NGA." *Maryland People's Counsel v. FERC*, No. 84-1090 at 13 (May 10, 1985) (*MPC II*). Traditionally, reviewing courts, as well as the Commission itself, have emphasized the FERC's duty to "weigh antitrust policy" in considering whether a proposed action is in the public interest. *Northern Natural Gas Co. v. FPC*, 399 F.2d 953, 958 (D.C. Cir. 1968); *Tenneco Oil Co.*, 20 FERC ¶ 61,030 (Jan. 16, 1984). Specifically, the Commission is required to "make findings related to the pertinent antitrust policies, draw conclusions from the findings, and weigh those conclusions along with other important public interest considerations." 399 F.2d at 961. *See also Gulf States Utilities Co. v. FPC*, 411 U.S. 747, 760 (1973); *City of Pittsburgh v. FPC*, 237 F.2d 741, 753-54 (D.C. Cir. 1956).

United States antitrust policy, as it has been developed and interpreted by the Supreme Court and lower federal courts, is not exclusively pro-competition. An exemption or immunity from federal antitrust liability has evolved in the case law with regard to certain anticompetitive action taken by a state or its delegate (either a political subdivision or a private party). This "state action exemption" is based on principles of federalism, and it is well established in the current federal case law.

The State Action Exemption

The state action exemption was first articulated by the Supreme Court in *Parker v. Brown*, 317 U.S. 341 (1943). In that case, the State of California had adopted a program for marketing its raisin crop which placed restrictions on the production and sale of raisins. Id. at 345-50. Faced with a potential conflict between state and federal law, the Court held that the anticompetitive marketing program, which was authorized by the state legislature, was exempt from the provisions of the Sherman Act. Id. at 350-52. The Court reasoned from principles of federalism that

> [i]n a dual system of government in which, under the Constitution, the states are sovereign, save only as Congress may constitutionally subtract from their authority, an unexpressed purpose to nullify a state's control over its offices and agents is not lightly to be attributed to Congress.

Id. at 351. Finding nothing in the language of the statute or its legislative history to suggest that its purpose was to restrain the activities directed by a state legislature, the Court held that "the Sherman Act . . . must be taken to be a prohibition of individual and not state action." Id. at 352.[1/]

Subsequent cases interpreting Parker make clear that the antitrust law state action exemption does not encompass all action taken under color of state law. In City of Lafayette v. Louisiana Power & Light Co., 435 U.S. 389 (1978), the Supreme Court established that Parker does not automatically confer state action immunity on municipalities because their actions are not necessarily the actions of a state. The plurality opinion suggested that a municipality could obtain Parker-type immunity by showing that it acted pursuant to a "clearly articulated and firmly expressed . . . state policy" to displace competition with regulation and that its actions were "actively supervised" by the state. Id. at 110. This inquiry, the Court concluded,

---

[1/] Although the basis for its decision was Congressional silence with regard to the anticompetitive actions taken by a state, the Court noted recently in Town of Hallie v. City of Eau Claire, 105 S. Ct. 1713 (1985) that there actually are affirmative expressions in the legislative history of Congress' "desire not 'to invade the legislative authority of the several states. . . .'" Id. at 1726 n. 19 (citations omitted).

would ensure that the state "legislatures contemplated the kind of action complained of," thereby justifying immunity from the antitrust laws. Id. at 415.

In California Retail Liquor Dealers Ass'n. v. Midcal Aluminum Inc., 445 U.S. 97 (1980), the factors raised in City of Lafayette, namely (1) a clear articulation of state policy and (2) active supervision by the state, were applied as a two-pronged test to determine whether certain private wine producers who set resale prices would be protected by the state action exemption. The Court found a clear legislative policy authorizing resale liquor price maintenance. The defendants failed the active supervision prong of the test, however, because the state had played no role in setting prices or reviewing their reasonableness. Id. at 105-06.

Recent Supreme Court Broadening of the Exemption

Two companion decisions of the Supreme Court, issued during its 1985 Term, have not only reaffirmed but broadened the state action exemption, by relaxing the criteria necessary to satisfy the two-pronged Midcal test. In Town of Hallie v. City of Eau Claire, 105 S. Ct. 1713 (1985), the Court addressed the application of the Midcal test to municipalities. In Southern Motor Carriers Rate Conference v. U.S., 105 S. Ct. 1721 (1985), the test's "clear articulation of state policy" prong was reviewed as applied to the anticompetitive activities of private parties and state regulatory agencies.

In Town of Hallie, the defendant City was charged with violating the Sherman Act by acquiring a monopoly over the provision of sewage treatment services and then tying those services to sewage collection and transportation services. Plaintiffs, four unannexed townships which had been denied treatment services by the City, argued first that the "clear articulation" criterion of the Midcal test was not met because the applicable statute neither explicitly referred to anticompetitive conduct nor compelled the City to act in an anticompetitive fashion. Second, plaintiffs argued that there was no active state supervision of the challenged conduct.

The Supreme Court rejected both of these arguments, and held that the actions of the City were exempt from the Sherman Act. In re-evaluating the "clear articulation" requirement, the Court held that state policy was sufficiently expressed so long as anticompetitive effects logically or foreseeably would result from the broad statutory authority to regulate. *Id.* at 1718-19. The Court further ruled that, although a statutory compulsion to act may be the best evidence of state policy, it is not a prerequisite for finding that a municipality acted pursuant to a clearly articulated state policy. *Id.* at 1720. In addition, the Court held that active state supervision is not required for exemption from antitrust laws when the actor is a municipality. The Court reasoned that the purpose of these requirements is to ensure that the actor is engaging in the challenged conduct pursuant to state policy. The more stringent criteria are required for situations in which the actor is a private party because there is a presumption that he is acting to serve his own interests rather than state interests. Municipalities, on the other hand, are presumed to be acting in the public interest. *Id.*

The Supreme Court's decision in the companion case, *Southern Motor Carriers*, *supra*, is particularly instructive for its application of the state action exemption to private, regulated utility companies. In *Southern Motor Carriers*, federal authorities challenged the collective ratemaking practices of private rate bureaus composed of common carriers which operated in four states. In three of the states, this type of anticompetitive conduct was specifically authorized but not compelled by the states' public utility legislation. In the fourth state, Mississippi, the relevant statute gave the public service commission authority to regulate common carriers, including the prescription of "just and reasonable" rates, but did not specify any details of the rate-setting process. The government conceded that there was sufficient state supervision of the challenged ratemaking activity in all four states, thus the second prong of the *Midcal* test was satisfied. The only issues before the Court were whether a private party's anticompetitive actions could be considered exempt in the absence of state compulsion and whether the regulatory schemes, particularly Mississippi's, satisfied the requirement of a "clearly articulated" state policy to replace competition with regulation. The Court answered both in the affirmative.

First, the Court rejected a compulsion requirement as being inconsistent with the values underlying the original *Parker* doctrine. The Court reasoned that such a requirement offends both the principles of federalism, by "reduc[ing] the range of regulatory alternatives available to the State," and of antitrust law, by forcing the states to impose *greater* restraints on trade. 105 S. Ct. at 1729. Second, the Court found that all the states' regulatory structures expressed a clear intent to displace competition with regulation, and that this satisfied the clear articulation requirement. It stated, generally, that

> [a] private party acting pursuant to an anticompetitive regulatory program need not "point to a specific, detailed legislative authorization" for its challenged conduct. . . . As long as the state as sovereign clearly intends to displace competition in a particular field with a regulatory structure, the first prong of the *Midcal* test is satisfied.

Id. at 1730-31 (citation omitted). The Court explained that if more detail were required of the state legislatures, "states would find it difficult to implement through regulatory agencies their anticompetitive policies." *Id.* at 1731.

State Regulation of Public Utilities and the State Action Exemption

As noted by the Supreme Court, the provision of retail natural gas service to the public is "essentially local" in character, and, therefore, was specifically left to state regulation under Congress' scheme of dual federal and state natural gas regulation. Panhandle Eastern Pipe Line Co. v. Public Service Commission of Indiana, 332 U.S. 495 (1947); Panhandle Eastern Pipeline Co. v. Michigan Public Service Commission, 341 U.S. 329 (1951).

Local gas distribution companies are regulated under state public utility laws. Although the specific statutes authorizing the regulation of public utilities differ from state to state, generally the states delegate regulatory authority to a state public service or public utility commission. This commission is responsible for approving the initiation and termination of service to consumers (*i.e.*, through the grant of a mandatory certificate of public convenience and necessity), monitoring and supervising the utilities' service, and establishing or approving all rates. If authorized by statute, state public utility commissions are even entitled to regulate the rates, Panhandle (Indiana), *supra*, and service, Panhandle (Michigan), *supra*, of interstate pipelines when they make direct sales to end-users.

With regard to antitrust considerations, state public utility law is settled on the point that a state has not only the right but the *duty* to protect public utilities from indiscriminate or destructive competition. *See*, *e.g.*, Kempsville Utility Co. v. Wills, 213 Va. 679, 194 S.E.2d 740, 742 (1973); Storey v. Mayo, 217 So.2d 304, 307 (Fla. 1968), *cert. denied*, 395 U.S. 909 (1969); Montana-Dakota Utilities Co. v. Johanneson, 153 N.W.2d 414, 420-21 (N.D. 1967); State ex. rel. Crown Coach Co. v. Public Service Commission, 238 Mo. App. 287, 179 S.W.2d 123, 126 (1944); Chicago Rys. Co. v. Commerce Commission, 336 Ill. 51, 67, 117 N.E. 840 (1929). As explained by an Iowa federal district court in Brady Transfer & Storage Co. v. U.S.,

> One of the underlying principles of regulation of utilities generally is that when the sovereignty assumes the power of regulation and requires the service and type of service which the regulatory authorities determine to be necessary and convenient in the public interest, then some measure of protection against indiscriminate and uncontrolled competition must be provided.

80 F. Supp. 110, 118 (S.D. Iowa), *aff'd per curiam* 335 U.S. 875 (1948).

The protection of public utilities from competition takes various forms, such as a state commission's grant of an exclusive franchise or service area to one public utility company over another. Many states' public utility statutes explicitly provide their state commissions with the authority to create exclusive franchises or otherwise suppress competition between utility companies offering the same service. *See*, *e.g.*, Conn. Gen. Stat. Ann. § 16-269 (West Supp. 1984) (pipeline operator may not compete for sales within franchise of LDC unless obtains consent of LDC or authorization by department of public utility control); Del. Code Ann. tit. 26, § 203 (Supp. 1984) (commission may prevent established LDC from being adversely affected by proposed extension of competitor); N.J. Stat. Ann. § 48:9-5 (West 1969) (subject to approval by state public utilities board, state and its municipalities may grant exclusive franchises); R.I. Gen. Laws § 39-17-2 (1984) (individual municipalities may grant exclusive franchise for up to 25 years); Va. Code § 56-265.4 (Supp. 1985) (second utility prohibited from operating in service area of certificate holder unless state corporation commission determines existing service is inadequate and certificate holder has had reasonable time to correct inadequacy); Wisc. Stat. § 196.50(1) (West Supp. 1984) (municipality may not grant license or franchise to second distributor unless state public utility commission determines, after notice and hearing, that public convenience and necessity so requires).

A recent Tenth Circuit decision, *Rural Electric Co. v. Cheyenne Light, Fuel & Power Co.*, No. 83-1415 (May 20, 1985) demonstrates the applicability of the state action exemption from antitrust liability to state-regulated public utilities. In that case, two public utility companies were competing before the Wyoming Public Service Commission for the right to serve a location in the City of Cheyenne. The City engaged in blatantly anticompetitive behavior in order to keep itself "under one power company." Antitrust claims against all parties -- the City, the favored utility, the public service commission, and various government officials -- were dismissed, however, pursuant to the state action exemption. The court found a clearly articulated state policy, namely, the statute compelling public utilities to obtain a certificate of public convenience and necessity from the state public service commission. This provided sufficient "compulsion" to engage in anticompetitive conduct, as well as the requisite "active state supervision" by the state commission. Thus, the anticompetitive conduct of a state acting through its public service commission, a political subdivision, and a privately incorporated public utility upon which it has conferred monopolistic status, was exempted from liability under the federal antitrust laws.

APPENDIX C

Capacity Utilization of
Four Major East Coast
Interstate Pipelines

Columbia Gas Transmission Corporation

While Columbia Gas Transmission Corporation (Columbia) has recently agreed to allow most of its customers to reduce their total daily entitlement (TDE) levels,[1] thus increasing Columbia's available capacity, it should be noted that this reduction will provide excess capacity on only some portions of Columbia's system. According to Columbia's marketing department, Columbia has no present capacity on the northern end of its system and does not expect excess capacity to develop in the near future.[2]

Moreover, prior to reducing its TDE levels, Columbia's 1984 peak-day deliveries were 7,226,181 dekatherms,[3] almost 94 percent of its customers' certificated daily requirements of 7,711,964 dekatherms.[4]

---

[1] See Order Approving Settlement as Modified, Columbia Gas Transmission Corporation, Docket Nos. TA82-1-21-001, et al. (issued June 14, 1985).

[2] See also "Supplemental Information Submitted in Response to a January 12, 1984 FERC [Data] Request - Item II," Columbia Gas Transmission Corporation, Docket No. CP84-2-000 (filed March 8, 1984) at 2-3 & accompanying flow diagrams (showing no available capacity at various points on Columbia's system).

[3] Source: Order Setting Case for Hearing, Columbia Gas Transmission Corporation, Docket Nos. CP84-2-000 and RP84-75-000, 29 FERC ¶ 61,099 at 61,187 (October 29, 1984).

[4] Source: Index of Purchasers, Columbia Gas Transmission Corporation Revised Tariff Sheet No. 76-82A (eff. April 15, 1984).

Texas Eastern Transmission Corporation

Texas Eastern Transmission Corporation (Texas Eastern) has little available pipeline capacity. This is evident from the fact that Texas Eastern's total firm sales, firm storage service and firm transportation service totaled over 1,038.9 MMdth for the twelve months ending April 30, 1984,[5] almost 93 percent of its customers' total certificated requirements of 1,121 MMdth.[6] Thus, even assuming that no bottlenecks restrict Texas Eastern's ability to increase its capacity, the pipeline's additional available capacity remains quite small.

Transcontinental Gas Pipe Line Corporation

Transcontinental Gas Pipe Line Corporation (Transco) also has little available excess pipeline capacity. In Transco's last major fully litigated rate case, it was shown that Transco's peak-day deliveries of 4,288,472 Mcf/d of natural gas to its jurisdictional firm sales customers constituted 93.3 percent of the certificated maximum daily entitlements of its firm sales customers.[7] Moreover, that proceeding also demonstrated that Transco is unable to serve the full contractual demands of all its firm customers on each and every day of the year.[7] Finally, AGD understands from Transco that Transco does not believe it presently has available sufficient excess pipeline capacity to support any significant additional firm or peak-day service to others.

---

[5] Source: Statement G, Texas Eastern Transmission Corporation, Docket No. RP84-108.

[6] Source: Gas Supplies of Interstate Natural Gas Pipeline Companies: 1983, DOE Energy Information Administration (November 1984) at 86.

[7] Source: Transcontinental Gas Pipe Line Corporation, Docket No. RP82-55-000, Transcript Vol. 21 at 2558-60 (February 7, 1984).

Tennessee Gas Pipeline Company, a Division of Tenneco, Inc.

Recently, the Commission approved a settlement agreement that allowed certain customers of Tennessee Gas Pipeline Company (Tennessee) to reduce their total certificated requirements and allowed other Tennessee customers to receive firm transportation service.[9] While these events might suggest the presence of spare capacity on the Tennessee system, the fact is that Tennessee has no spare capacity on certain portions of its system. The Commission recently recognized these capacity problems in its order approving and modifying the recent Tennessee settlement agreement. The Commission there noted that:

> Tennessee's gas marketing efforts in the New England area have been historically restricted by the lack of available pipeline capacity. In addition, numerous New England area distribution companies have been hampered in efforts to obtain additional firm volumes during the winter heating season by the lack of excess transportation capacity in Tennessee's system.[10]

Thus, while Tennessee may have some additional capacity on its system, it is apparent that there is no excess capacity on the portions of Tennessee's system where demand is greatest.

As the above discussion makes clear, there is a critical need for the Commission to examine carefully each pipeline's ability to make available additional firm capacity in each marketing area before allowing a "non-discriminatory access" policy to impair existing service to firm customers.

---

[8] Id. Transcript Vol. 10 at 818 (January 20, 1984).

[9] Order Modifying and Approving Contested Settlement, Tennessee Gas Pipeline Company, a Division of Tenneco, Inc., Docket Nos. RP83-8-000, et al., 31 FERC ¶ 61,308 (June 14, 1985).

[10] Id.

APPENDIX D

Reform of Rate Case Procedures

In its comments submitted in response to the Phase II and III Notice of Inquiry in this proceeding, AGD recommended that the Commission exercise its rulemaking authority to bring about certain changes in pipeline rate case procedures. The ratemaking implications of the four major proposals outlined in the NOPR necessitate further consideration of rate case procedural reform.

AGD's recommendations in its Phase II and III comments emphasized the need for removing existing incentives for multiple and excessive pipeline rate filings. The Commission's present intent to permit a freer rein for market allocation of risks -- manifested particularly in the optional certificate and PGA block pricing proposals -- make it imperative that pipelines no longer find a safe haven in frequent and excessive rate filings.

The principal recommendation in AGD's Phase II and III comments on rate case procedural reform is to increase the currently effective interest rate on rate case refunds from the average prime rate (*see* 18 C.F.R. § 154.67) to *at least three points above the prime rate*. The purpose of this recommendation is to discourage pipelines from filing excessive rate increases which they typically collect for several months after a brief five-month suspension. The pipelines thus enjoy the use of hundreds of millions of dollars at very favorable rates. As AGD pointed out in its comments, the "cost" of this loan to distribution companies and their customers includes not only the excess dollars paid to the pipelines but also the market losses that result from the excessive rates while they remain in effect.

For the convenience of the Commission, AGD's March 11, 1985 comments on this point are reproduced here as follows:

> AGD recommends that the Commission modify its refund regulations so that pipelines become less prone to use NGA Section 4 rate filings as a risk avoidance strategy in the future. While the NGA prescribed five-month period may have been sufficient for the full adjudication of a pipeline rate case in 1938, rate proceedings have become considerably more complex over the last 45 years. Under current conditions, FERC hearings rarely even commence within the five-month suspension period, and a Commission decision is scarcely if ever rendered within two years of a contested rate filing. Once the five-month period is exhausted, however, the filed rates go into effect, without regard to whether they meet the requirements of the NGA.
>
> Payments made under these unapproved rates are subject to refund with interest. Unfortunately, the Commission's current refund procedures are painfully inadequate. Because interest rates are set only at the level of the prime rate, an excessive rate increase request by a pipeline company operates to the advantage of that pipeline, and to the prejudice of its customers. After the expiration of the five-month suspension period, the pipeline begins to collect the excessive rates. These payments will eventually be refunded, but in the meantime the pipeline has the use of considerable sums of money to which it has only a contingent right at best. The pipeline has, in effect, received a large and favorable loan from its customers.
>
> The pipeline's customers, similarly, are forced to pay excessive rates for a period of as much as two or three years. Distributors may lose some of their existing customers as end-users switch to alternative energy sources. Such load loss, which may be irreversible, forces remaining customers to pay a higher percentage of the distributor's overhead. Further, distributors become less competitive for new customers vis-a-vis competing energy suppliers. Pipelines, distributors, state commissions and others are fully aware of the consequences of payment subject to refund. As the five-month suspension period moves toward a close, the pressure increases for parties opposing the pipeline to accept a less favorable settlement on the proposed rates.[10] In some cases, a number of rate increases for a single pipeline are pending at the same time, posing the risk of massive rate hikes and giving extraordinary leverage to the pipeline. The net effect is a classic Hobson's choice: pipeline customers, state commissions and others can make the free choice of accepting a modest, albeit unjustified, pipeline rate increase or continue to oppose any rate increase and suffer the consequences of a substantial increase in the interim.

10/ The situation described here tends to be a more serious problem for those customers which rely on a single pipeline supplier for all their pipeline gas and thus have no ability to modify their pipeline purchase pattern to mitigate the burden of paying higher pipeline rates pending FERC action.

> The key element of FERC discretion to change the present system is in the power to prescribe the appropriate interest rate at which pipeline overcharges are made. As indicated, the present system -- based on the use of an average of prime rates prevailing during the increased rate collection period 11/ -- provides a rate too low to operate as a rate increase disincentive. Accordingly, the Commission should consider some alternative interest level, such as several points above the prime rate. In other words, the interest to be paid on overcharges refunded to the pipelines' customers would be at least several points above the average prime rate prevailing over the period of the rate increase in question. To the extent that the pipeline's interest obligation on overcharges is fixed at a level below this, the pipeline will continue to regard the general rate increase filing as an attractive source of new capital and will retain the existing incentive to use its rate increase initiative as a vehicle for shifting or escaping the risk of competition.

AGD reiterated its rate case procedural reform recommendation at the public hearing conducted on March 28, 1985. There, Commissioner Richard requested that the record be supplemented with specific examples of cases in which pipelines may have taken advantage of the existing procedures which place no limits on the number of consecutive rate filings or the amount of proposed rate increases. (Transcript, March 28, 1985, at 144-49).

The Pressures of "Pancaking"

The Section 4 rate case filings by Transcontinental Gas Pipe Line Corporation (Transco) from 1976 through 1983 present an illustration of the problems created by consecutive rate filings, sometimes referred to as "pancaking". Attached to this Appendix C as Exhibit C-1 is a chart showing the results of a series of rate filings by Transco from October 1981 through September 1983. This series of filings, made during a period of excess gas supply and rising gas prices, exerted considerable pressure upon Transco's customers to settle these cases as soon as possible. For example, in the midst of extensive settlement negotiations in Docket No. RP80-117, a

---

11/ 18 C.F.R. § 154.67 (1984).

case filed on June 30, 1980, Transco filed another general rate increase on October 31, 1981 in Docket No. RP82-3. That rate filing was withdrawn before it became effective as part of the settlement conditions agreed to in Docket No. RP80-117. A similar pattern is evident in the disposition of Transco's subsequent rate filings in Docket Nos. RP82-55 and RP83-11 (See Exhibit D-1).

The pressures of inter-fuel competition reduce a pipeline's incentive to "pancake" rate filings. Some evidence of that may be seen in the fact that Transco's last major rate increase was filed on September 30, 1983. Similarly, the pressures of inter-pipeline competition may further reduce the incentive to pancake. AGD believes, however, that a refund rate at least three points above prime would provide an effective safeguard which would not fail even in the absence of inter-fuel and inter-pipeline competition. AGD, therefore, urges the Commission to adopt its refund rate recommendation.

Other Rate Case Reforms

In addition to its refund rate recommendation, AGD proposes that the Commission include in any rulemaking proposal dealing with rate case procedures the following changes:

-- A longer notice requirement -- *e.g.*, at least sixty days, as required in the case of electric rate filings pursuant to 18 C.F.R. § 35.3:

-- Supplemental information requirements -- *e.g.*, responses to a standardized data request which would reduce the time expended by Commission Staff and pipeline customers to compile the data necessary to understand the changes proposed by the pipeline;

-- Strict compliance requirements -- *e.g.*, *rejection* of any rate filing in which the information furnished is deficient, unless the pipeline voluntarily extends the notice period until the deficiency is corrected.

These proposed reforms are intended to reduce the time during which rate increases in excess of those ultimately approved would remain in effect. The longer those rates remain effective, the more likely they are to cause irrecoverable loss of markets for pipeline customers.

A recent rate filing by Texas Eastern Transmission Corporation (TETCO) provides yet another example. On August 13, 1984, TETCO submitted a 36-month compliance filing pursuant to 18 C.F.R. § 154.38(d)(4)(vi) (Restatement of Base Tariff Rates). In that filing, TETCO proposed base tariff rate adjustments to produce additional revenues of approximately $121 million and an increase of about 10 cents per dt in its Zone D rates (on a 100-percent load factor basis). The proposed rates became effective (subject to refund) February 13, 1985. A concerted effort by TETCO and its customers produced a proposed settlement submitted to the Presiding Judge on April 26, 1985, calling for an average reduction of two cents per dt in the currently effective base rates. On June 28, 1985, the Presiding Judge certified the settlement to the Commission over the objections of Commission Staff, the Pennsylvania Public Utility Commission, the Pennsylvania Consumer Advocate and Cincinnati Gas & Electric Company. Meanwhile, the higher filed rates have remained in effect for five months with the result that TETCO's customers may suffer market losses.

The procedures proposed above would have helped the parties to avoid this state of affairs. A longer notice requirement coupled with the required filing of responses to a standardized data request would have enabled the parties to get to the central issues more quickly, even before the start of the five-month suspension period.

A principal issue in the TETCO case has been the appropriate level of sales volumes to be used in calculating TETCO's cost of service. This issue has been critical in nearly every major rate case filing during the past few years, and its importance will surely increase in the future. A standardized set of data requests would provide a baseline of information on the issue in every case. This information requirement, if strictly enforced by liberal exercise of the Commission's power to reject deficient filings, would help to delay the effectiveness of increased rates at levels that, in many cases, neither the pipeline nor its customers can tolerate in today's market.

A pipeline's obligation to supply additional information with its initial rate filing should be enforced with particular strictness where the pipeline proposes a significant change in any major component of its cost-of-service or rate design which would have the effect of increasing its rates. This would include, for example, a proposed increase in its operating and maintenance expenses in excess of inflation, a reduction in its projected sales volumes, an increase in its rate of return, etc.

If the pipeline fails to meet its information requirements in such cases, its filing should be rejected, unless the pipeline voluntarily agrees to extend the notice period until it has fully satisfied the filing requirements. In other words, in cases where a pipeline proposes significant changes, the presumption should be that any deficiency in the initial filing which may delay resolution of the case beyond the effective date of the proposed rates will result in rejection of the filing unless the pipeline voluntarily extends the notice period.

Further progress in expediting rate case procedures would be made if major changes in cost classification, allocation or rate design were first considered in a generic proceeding rather than in individual rate cases. The Staff's recent advocacy of a modified fixed/variable rate design with a two-part demand rate structure offers an obvious case in point. Much time and duplicative effort has been spent in individual cases developing a record on this subject. Exploration of the issues first in a generic context could have produced guidelines which could then have been tested more efficiently in individual cases.

The foregoing proposals are merely suggestive of some measures which might be adopted to improve rate case procedures. They are in no sense exhaustive, but are presented principally in response to Commissioner Richard's inquiry as examples of the kinds of needed improvements which should be considered as soon as possible by the Commission.

EXHIBIT D-1

TRANSCONTINENTAL GAS PIPE LINE CORPORATION
RATE CASE HISTORY

Docket	Proposed Zone 3 Rates	Date of Settlement	Zone 3 Settlement Rates	Comments
RP76-136 (filed 7/30/76)	Demand $2.13 Commodity 103.8¢	6/27/78	Demand $2.08 Commodity 109.5¢	Refunds due to zone differential issue paid October, 1981 for period covering 8/9/79 through 8/31/81.
RP77-108 (filed 7/1/77)	Demand $2.54 Commodity 120.6¢	10/11/79	Demand $2.08 Commodity 113.60¢	
RP80-117 (filed 6/30/80)	Demand $3.39 Commodity 250.17¢	3/12/82	Rate levels adjusted back to 12/31/80 "pre-filed rates": Demand $2.08 Commodity 297.24¢	Transco agreed to refund total amount collected from and after 1/1/81 from each affected customer in excess of "pre-filed rates." Additionally, Transco agreed to make a single lump-sum refund of $25 million, without interest.
RP82-3 (filed 10/31/81)	Demand $3.91 Commodity 335.54¢	3/12/82		Withdrawn as part of settlement conditions in Docket No. RP80-117.
RP82-55 (filed 3/31/82)	Demand $4.57 Commodity 372.20¢	10/8/82	Option A - Demand $7.34 Commodity 353.80¢ Option B - Demand $6.74 Commodity 351.80¢	Settlement certified to Commission; Option B rates approved 2/10/83.
RP83-11 (filed 10/22/82)	Demand $8.31 Commodity 362.40¢	4/19/83	Demand $7.06 Commodity 384.60¢	Initial filing suspended, to become effective April 22, 1983 unless Option A settlement rates were approved in RP82-55; settlement rates approved 4/28/83
RP83-137 (filed 9/30/83)	Demand $7.87 Commodity 379.70¢	4/1/84	Demand $7.22 Commodity 375.41¢	Settlement rates approved 7/25/84

EXHIBIT A

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

REGULATION OF NATURAL)
GAS PIPELINES AFTER)
PARTIAL WELLHEAD DECONTROL) DOCKET NO. RM85-1

Prepared Testimony of Louis A. Guth Concerning Allocating Pipeline Capacity in Periods of Shortage on Behalf of Associated Gas Distributors

---

1. The Notice of Proposed Rulemaking in Federal Energy Regulatory Commission Docket RM85-1, concerning Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, anticipates that natural gas pipelines will continue to shift their emphasis to providing transportation services to on-system customers and others who directly purchase some or all of their natural gas requirements in the field.

2. It seems likely that some customers requiring transportation service will seek to obtain firm service. The price for this service will include a charge for recovery of and return on the investment of the pipeline in its facilities, i.e., a demand charge. This is so whether that charge is separately specified in the contract for firm service or, as the FERC would seem to prefer, included in a specified volumetric charge with associated contract provisions providing for actual and minimum volumes to be carried.

3. At the same time, some -- and perhaps many -- traditional resale customers of pipelines may find it to their advantage to retain the

traditional integrated services provided by pipelines. These include acquisition of gas supply, transportation and storage, and general management of gas resources required by the customer. These customers will also require firm access to the pipeline on similar terms and conditions to those described above.

4. Thus there will doubtless be a mixture of firm and nonfirm services provided by pipelines. The contours of this mixture will be determined by the needs of consumers who express those needs in a more market-responsive environment through the dollars they are willing to pay for various services.

5. As I understand the East Coast markets and the pipelines which serve those markets, current and reasonably anticipated firm demands are likely to require essentially all of the present capacity of the pipelines during peak winter periods. At such times, rates on all gas carried -- established in whole or in part through regulatory review -- are likely to include a return on and of capital investment of the pipeline.

6. Conversely, during off-peak periods in the summer, pipelines serving the East Coast may have capacity to handle essentially all nonfirm demands likely to arise. By that I mean specifically assuming that pipelines make their capacity above firm requirements available at prices at or near the short-term marginal costs of operations. Thus prices for nonfirm service would be set essentially at direct operating costs of the pipeline.

7. Starting with that base off-peak level, nonfirm demands may grow sufficiently to exhaust available capacity above firm requirements. From an economic perspective, one would expect that, as nonfirm demand begins to press against available capacity, the price for this service will rise well above short-term marginal costs, thus helping to balance off demand and supply and retain market equilibrium.

8. Thus, in what may be termed "shoulder periods" for gas demand in East Coast markets, it seems likely that there will sometimes be a need to ration available gas pipeline capacity. This can be accomplished through the market mechanism by prices, or by other means.

9. Rationing through prices is preferable as a general rule. In this way, those consumers with the highest marginal value for a service are able to obtain it. However, there are a number of problems that would make this approach difficult in practice. First, markets are not perfectly competitive. The transportation of gas into geographic markets along the East Coast is, in many cases, performed by only one or two pipelines. Thus pricing in these circumstances may not represent a proper balancing of demand and available supply. Second, the contracts pursuant to which nonfirm gas is transported may have been signed well in advance of the actual occurrence of shortage. Unless the customer can forecast requirements on the pipeline very well -- and beyond the uncertainties associated with weather conditions -- he would be at a considerable disadvantage in trying to assess the value to him of nonfirm service at a variable price.

10. In these circumstances, we frequently resort to other means of allocating available capacity. A familiar example is the over-booked airplane flight. In this case, rather than directly and unfairly raising the price to weed out passengers, an alternative mechanism is used. Passengers with a low value in taking the immediate flight are, in effect, "bribed" with a cash payment or other perquisite to switch to a later flight.

11. In natural gas, a traditional response to shortages (of another sort) has been to establish priorities of service. This has been done either through established priority lists for various classes of customers, or through

establishing "interruptible" nonfirm service, or both. Decontrol of wellhead pricing and encouragement of market-oriented behavior have obviated the need for direct allocations of gas supplies. But the circumstances of the East Coast -- at least -- suggest that there will have to be some procedures for establishing who is interrupted and who is not under the "shoulder period" circumstances described above. Several possibilities come to mind.

12. Probably the preferred economic approach would be to permit the pipeline to charge for multiple levels of "interruptibility," i.e., customers who are willing to pay to stand first in line after firm requirements are met should be allowed to do so, and so forth. A problem with this approach is that it leaves some added uncertainty for customers who could find themselves pushed further and further back in line if demand for nonfirm services grows. The tendency might be, therefore, for all customers to pay the "insurance" to stand first in line after firm customers, thus defeating the purpose of the system. Reinforcing this tendency would be whatever market power some pipelines might possess in separate geographic markets.

13. A second approach is, in effect, "first come, first serve." As always, there is much to recommend this standard in terms of inherent "fairness." There is, however, very little to say for it from the standpoint of economics. Moreover, the standard might prove to be very difficult to interpret if consumers, recognizing the game being played, file "early and often" for nonfirm service so as to reserve a place in line.

14. A third and final approach to be considered here is setting some priority standards. One specific example would be to put the nonfirm requirements of firm customers first in line when pipeline capacity is unable to meet all demands. As with any such scheme, there is a cost in using direct allocations

instead of market prices to determine who gets access to the pipeline. But there would appear to be some positives to this scheme as well, beyond the removal of some uncertainties described above.

15. First, these firm customers -- in particular the Local Distribution Companies (LDCs) -- almost certainly serve loads which are the least flexible in switching to alternative fuels. Nevertheless, where field market circumstances create opportunities for the LDCs to purchase attractively priced gas, they should not have the added risk of being bumped first by a pipeline which may have some market incentive to do so.

16. Second, since the LDCs and other firm customers do serve loads which are likely less amenable to fuel switching, in the event of necessary interruptions, the impact would likely be most widely felt if end-use customers of LDCs were involved.

17. Third, there is much to be said for encouraging firm customers to fine tune their demands so as not overly to restrict access to the pipeline. That is, firm customers may be willing to cut back on firm requirements if they have some predictable access to interruptible or off-peak capacity. This would likely have the effect generally of increasing a pipeline's capacity to serve nonfirm customers. Moreover, this would further encourage LDCs and other firm customers to aggressively seek out the best field market opportunities for at least a portion of their supplies.

18. Fourth, under present practice, there are at least two kinds of indirect economic benefits enjoyed by the captive residential and small commercial customers as a result of LDCs securing interruptible service. First, the revenues derived by LDCs from interruptible sales are generally used to reduce the LDCs' rates to firm customers. Second, the LDCs' purchase of

interruptible gas from their pipeline suppliers enhances the LDCs' ability to satisfy their minimum bill purchase requirements, thereby reducing the average cost of gas.

19. In the end, it must be kept in mind that we are dealing with limited circumstances -- the "shoulder" period -- in which the characteristics of contracts and of market circumstances in the natural gas industry might not make appropriate otherwise preferred market solutions to capacity limitations on pipelines. In this case, assuming the empirical evidence supports the likelihood that (a) some approach will be needed and that (b) decision-making of LDCs and other firm customers of pipelines will be enhanced, assigning a first priority to nonfirm loads of firm customers makes a good deal of economic sense as well as common sense.

Attachment A
of Exhibit A

LOUIS A. GUTH

Mr. Guth is a Senior Vice President of National Economic Research Associates, Inc. He received his Bachelor's degree in Economics from Harvard University and his Master's degree in Economics from the University of Pennsylvania, specializing in industrial organization. He has taught at the University of Pennsylvania and was an Assistant Professor of Economics at the Graduate School of Business Administration, New York University. He has prepared studies on the interrelationships of market structure, advertising behavior, risk and rate of return and has published in The Journal of Industrial Economics. He has prepared numerous reports and testimony dealing with antitrust matters concerning reciprocity, market structure and mergers, particularly the effects of conglomerate mergers.

Mr. Guth has also done substantial work in regulatory matters, including the quantification of economic demand and cost concepts and the development of policies to balance competitive and regulatory objectives. His studies include detailed statistical analysis of costs in the stock brokerage industry and a review of proposals to modify the extent of competition between scheduled and non-scheduled air passenger services. He has prepared studies of the role and quantification of economic cost concepts in regulation of communications and other companies. He has performed an extensive analysis of the elasticity of demand for electric power of the major customer classes. Based on this analysis, he has prepared reports and testimony developing forecasts of growth in energy and peak demand for electricity for approximately 30 electric utilities. Mr. Guth has also developed NERA's regional gas demand model, RGD and NERA's energy forecasting model, NERAGEM. He has participated in and prepared numerous analyses concerning national and regional natural gas policy. He supervises NERA efforts in forecasting state-specific, regional and national projections of gas, electricity and oil requirements, and gas wellhead and burner-tip prices. He has appeared as an expert witness before the SEC, the FPC, the FERC, the CAB, the NRC and state regulatory commissions, as well as Federal District Courts.

Senator NICKLES. Thank you very much, Mr. Bunn.
Mr. Stewart.

STATEMENT OF ROBERT W. STEWART, CHAIRMAN, PRIMARK CORP.

Mr. STEWART. Chairman Nickles, thank you very much. I am chairman of Primark Corp. Our major asset is Michigan Consolidated Gas Co. that operates in Michigan, basically a distribution company, but we also provide storage services, transportation, and buy gas in the State of Michigan from producers.

Unlike many, we strongly support the concept of the FERC proposed rulemaking, and I would like to take 1 minute to give you the perspective we're coming from. The current system, as we see it, where we're the end of the line, has left us in the situation that we have high demand costs to pay to pipelines. In our case, we're paying almost $350 million per year, and that cost is there whether we buy any gas from the pipeline or not.

We have recently been relieved of take-or-pay obligations on commodity costs, but those were huge obligations also. We have been frozen out of the transportation market. What's going on as we see it today is pipelines have been seeking out to serve industrial markets, discounting their transportation rates much lower than we have to pay them for our gas, and we think those things are deserving of change.

We think the concepts in the NOPR are sound and I think that the FERC, with the hearings that they've had and with the millions of pages of testimony, will make some revisions that will even make this a more workable proposal.

We basically favor the benefit—the NOPR because of the benefit to the consumers. In our company's case, we see our customers being able to reduce their gas bills by $150 or about 15 percent, and that's a conservative estimate. And I think that is something the Congress needs to take account of as they consider their reaction to the NOPR. This is really a consumer benefit proposal.

We think that's brought about by basically two features of the NOPR. One is separation of old gas prices from all other gas prices. What we have seen and observed in the buying practices of natural gas pipeline companies in many cases is really where they have paid excessive prices. There is no one that can contest those under the NPGA because you can only contest them if you can prove fraud or abuse.

So the pipelines are free to buy what gas they want to, and we have seen gas prices, as you know, as high as $11 and still a lot of gas being bought and produced at above market-clearing prices. We don't quite understand why that makes sense in the long run; therefore, we are for the benefit that will derive to the consumer.

I think small producers particularly who have old gas that now not be able to produce it because pipeline companies are blending their production and prices, and I think there's quite a bit of old gas that's not now being produced. I think the NOPR will ensure that all old gas will be produced and could very well benefit many small producers.

The second feature of the NOPR we like is the opportunity to have gas transported for us. Pipelines have discriminated against distribution companies in that they have refused to transport gas. For us, the ability for us to reduce our contract obligations as well as the pipelines' contract obligations and thereby reduce our demand costs will only inure to the benefit of our consumers.

Gas market prices today are really in a very dramatic and dynamic situation. I am sure you all have read about what's happening to oil prices or what could happen to oil prices, and we need a system where we have an ability to put pressure on the pipelines to deliver us competitive gas. That does not exist today, and that's why we favor the ability to go out and buy gas from producers, and I think that we could reach good accommodations with producers, although I do not ever think the pipelines will ever go out of the business of supplying gas.

Our demand has gone down by a third. Our prices have doubled. I think that we need to get a more competitive situation in the gas business, and the NOPR certainly moves in that direction.

Thank you very much, Senator.

[The prepared statement of Mr. Stewart follows:]

Statement of Robert W. Stewart
Chairman, Primark Corporation,
before the Subcommittee on Energy
Regulation and Conservation
September 19, 1985

Chairman Nickles, committee members, ladies and gentlemen. My name is Robert W. Stewart, and I am testifying today on behalf of Michigan Consolidated Gas Company and its customers in support of the Federal Energy Regulatory Commission's proposed rulemaking.

Michigan Consolidated is the nation's fifth largest gas distribution company, serving more than one million residential, commercial and industrial customers throughout Michigan. MichCon is also the largest subsidiary of Primark Corporation, of which I am chairman.

MY 21 YEARS OF EXPERIENCE IN THE NATURAL GAS FIELD, 12 AS AN EXECUTIVE OFFICER AND CHAIRMAN OF MICHCON, COMPEL ME TO APPEAR BEFORE YOU TODAY BECAUSE WE ARE PRESENTLY FACED WITH AN INDUSTRY THAT IS PLAGUED WITH MASSIVE PROBLEMS. FOREMOST ON THE LIST ARE: (1) THE INABILITY TO MOVE LOW-COST GAS SUPPLIES TO MARKET AT WHAT COULD BE AN ENORMOUS SAVINGS TO CUSTOMERS, (2) THE SALE OF HIGH-COST GAS SUPPLIES BY PRODUCERS AND PIPELINES AT LEVELS THAT ARE CLEARLY UNMARKETABLE, AND (3) A CONTINUING LOSS OF MARKETS TO COMPETITIVE FUELS.

THESE PROBLEMS STEM FROM A REGULATORY SYSTEM THAT WAS PUT IN PLACE TO ANSWER ENERGY SHORTAGES OF THE PAST AND IS UNRESPONSIVE TO DEMANDS OF THE PRESENT OR FUTURE. IT HAS UNJUSTLY HURT THOSE IN THE INDUSTRY WHO ARE AT THE RECEIVING END -- GAS DISTRIBUTORS AND THE CONSUMING PUBLIC. BUT, IT CAN BE EFFECTIVELY REMEDIED BY THE PROPOSED CHANGES NOW BEFORE THE FERC. LET ME EXPLAIN.

IN 1978, WHEN CONGRESS WAS PUTTING TOGETHER THE NATURAL GAS POLICY ACT, THE NATION WAS CONCERNED THAT WE WERE RUNNING OUT OF NATURAL GAS. WE HAD TO CONSERVE EXISTING GAS RESERVES AND ENCOURAGE THE PRODUCTION OF NEW SUPPLIES.

THE METHOD CONGRESS USED WAS TO PROVIDE ECONOMIC INCENTIVES BY ALLOWING PRODUCERS TO GET MORE MONEY FOR NEW GAS. WHEN WE LOOK AT THE GAS INDUSTRY'S SURPLUS SUPPLY SITUATION TODAY, I THINK WE CAN ALL AGREE THAT PAYING MORE MONEY FOR GAS DID, INDEED, GET US MORE GAS.

THE NGPA SOLVED THE SUPPLY PROBLEM, BUT IT WAS MISUSED BY PIPELINES AND PRODUCERS, CREATING PRICING PROBLEMS THAT HAVE HAD SERIOUS IMPLICATIONS FOR LOCAL DISTRIBUTION COMPANIES, LIKE MICHCON, AND THE ULTIMATE CONSUMERS WHICH THEY SERVE.

SINCE 1978, MICHCON HAS SEEN ITS AVERAGE COST OF GAS MORE THAN DOUBLE AND ITS SALES DROP BY ALMOST ONE-THIRD. AS ONE WOULD EXPECT, NUMBERS LIKE THESE HAVE PRODUCED UNHAPPY READING FOR THE SHAREHOLDERS OF LOCAL DISTRIBUTION COMPANIES, JUST AS THEY HAVE FOR CONSUMERS READING THEIR MONTHLY GAS BILLS.

NOT EVERYONE, HOWEVER, HAS SHARED IN THE RISK OR PROBLEMS OF THE INDUSTRY. THOSE WHO HAVE PROSPERED UNDER THE CURRENT SITUATION CAN BE QUITE READILY IDENTIFIED. THEY ARE THE PIPELINES AND THE PRODUCERS SELLING HIGH COST GAS.

WHILE DISTRIBUTION COMPANIES' PROFITS HAVE BEEN DEPRESSED, PIPELINES HAVE EXPERIENCED RECORD PROFITS AND RETURNS IN THE 15 TO 20 PERCENT RANGE DESPITE DECLINES IN SALES SIMILAR TO THOSE OF DISTRIBUTORS. INDEED, PIPELINES HAVE BEEN VIEWED AS EXTREMELY ATTRACTIVE TAKE-OVER TARGETS BECAUSE OF THEIR HIGH EARNINGS POTENTIAL.

NOW, EVERY COMPETITIVE CONTEST HAS ITS WINNERS AND LOSERS -- THAT'S TO BE EXPECTED. BUT, TO BE PENALIZED BEFORE YOU EVEN TAKE THE FIELD IS SOMETHING ELSE AGAIN. THAT'S WHAT HAS BEEN HAPPENING TO DISTRIBUTION COMPANIES IN THE NATURAL GAS INDUSTRY. PIPELINES HAVE BEEN ABLE TO THRIVE IN THE SAME ECONOMIC ENVIRONMENT THAT HAS MADE DISTRIBUTORS ANEMIC.

THE REASON IS THAT CURRENT REGULATIONS HAVE ALLOWED PIPELINES TO SIMPLY PASS THROUGH THEIR TOTAL COSTS TO CUSTOMERS, THUS INSULATING THEMSELVES FROM MARKET RISKS. THE RESULT HAS BEEN UNMARKETABLE PRICES FOR DISTRIBUTORS AND A FURTHER REDUCTION IN SALES LEVELS.

THIS HAS HAPPENED IN SPITE OF THE FACT THAT PIPELINES HAVE AUTHORED THEIR OWN MISFORTUNE THROUGH THEIR UNWILLINGNESS TO TAKE ACTIONS TO CONTROL THE PRICES THEY PAID FOR GAS. IN SHORT, UNDER CURRENT CONDITIONS, PIPELINES HAVE VIRTUALLY NO BUSINESS RISK.

PRODUCERS OF HIGH-COST GAS WITH HIGH TAKE PROVISIONS IN THEIR SALES CONTRACTS HAVE ALSO DONE WELL UNDER THE PRESENT STATE OF AFFAIRS. THIS IS BECAUSE THE FERC'S PRESENT BILLING MECHANISM PERMITS PIPELINES TO MASK PURCHASES OF HIGH-PRICED GAS SUPPLIES BY ROLLING THEM IN WITH "OLD" GAS PURCHASES.

FOR EXAMPLE, A PIPELINE MAY PURCHASE "OLD" REGULATED NATURAL GAS AT $1 TO $2 PER THOUSAND CUBIC FEET (MCF) AND THEN BUY DEREGULATED GAS AT $5 TO $10 PER THOUSAND CUBIC FEET. THESE HIGH PRICES ARE LUDICROUS IN TODAY'S MARKET -- APPROACHING THE EQUIVALENT OF $60 PER BARREL OF OIL. CONSUMERS WOULD OBVIOUSLY BE UNWILLING TO PAY FOR THEM. HOWEVER, PIPELINES SELL THEIR GAS TO DISTRIBUTION COMPANIES AT A "BLENDED" OR AVERAGE PRICE, AND CONSUMERS DON'T SEE THE WILD VARIATIONS IN PRICE THAT ACTUALLY EXIST. IN ADDITION, A PRODUCER WHO SELLS HIGH PRICED GAS TO A PIPELINE HAS THE MISTAKEN IMPRESSION THAT HIS IS A MARKETABLE PRICE, WHEN IN FACT IT IS NOT.

I CANNOT EMPHASIZE ENOUGH THE CHAOTIC SITUATION IN THE INDUSTRY. AT A TIME WHEN SUPPLIES FAR EXCEED DEMAND, AND MARKETS CONTINUE TO FALL, PRICES REMAIN ABOVE MARKET CLEARING LEVELS. PIPELINE AND PRODUCER CONTRACT PRACTICES SIMPLY DO NOT REFLECT SIGNALS FROM CUSTOMERS. ROLLED-IN PRICING AND RISK-FREE REGULATIONS PROVIDE NO INCENTIVE FOR PIPELINES AND PRODUCERS TO ACCEPT CHANGE. AS BENEFICIARIES UNDER THE PRESENT SYSTEM, THEY SAY "LEAVE EVERYTHING THE WAY IT IS -- WE DON'T SEE ANY PROBLEM HERE."

IN FACT, SOME OF THEM BLATANTLY PREDICT THAT REGULATORY REFORM WILL BRING ABOUT NEW GAS SHORTAGES IN PLACE OF THE CURRENT SURPLUSES. I THINK THEY ARE MISSING THE POINT. THE SURPLUSES ARE THE RESULT OF THE HIGH PRICES THE PIPELINES AND PRODUCERS CONTINUE TO ENFORCE. THEY HAVE DRIVEN CUSTOMERS AWAY BECAUSE THEY ARE NOT MARKET SENSITIVE.

IS THIS LOSS IN SALES NECESSARY TO ENSURE A FUTURE SUPPLY? MY COMPANY BELIEVES THAT THE CURRENT PRICE FOR "SECURITY" OF THIS SURPLUS IS JUST TOO HIGH. SURELY THERE MUST BE A MORE REASONABLE BALANCE THAT CAN BE REACHED ON THE SUPPLY AND DEMAND CURVES OF THE GAS MARKET; A POINT WHERE MARKET FORCES WILL ASSURE ADEQUATE SUPPLIES OVER THE LONG TERM AT MARKET-BASED PRICES.

I STRONGLY BELIEVE THAT THE FERC'S NOTICE OF PROPOSED RULEMAKING IS ON THE RIGHT TRACK TOWARD A PERMANENT SOLUTION TO THIS PROBLEM OF BALANCE. LET ME FOCUS ON TWO PARTICULAR ASPECTS OF THE NOPR TO ILLUSTRATE WHY IT WILL WORK.

FIRST, THE COMMISSION HAS ADDRESSED THE PROBLEM OF FALSE MARKET PRICES FOR NEW GAS BY PROPOSING THAT PRE-NGPA, PRICE-CONTROLLED GAS BE SEPARATELY BILLED BY PIPELINES. SEPARATE BILLING WOULD SET OUT THE REAL PRICE OF NEW GAS FOR ALL TO SEE.

IN THIS WAY, POTENTIAL GAS PURCHASERS WOULD BE ABLE TO MAKE THEIR INCREMENTAL PURCHASING DECISIONS BASED ON THE CURRENT COST OF NEW GAS AND PRODUCERS WILL HAVE AN ACCURATE READING OF THE MARKET VALUE OF THEIR PRESENT AND FUTURE GAS SUPPLIES. UNLESS PRE-NGPA GAS IS SEPARATELY PRICED, AS THE COMMISSION PROPOSES, IT WILL CONTINUE TO DISTORT INCREMENTAL PURCHASING AND PRODUCTION DECISIONS AND CONTINUE TO MAKE AN UNREGULATED WELLHEAD MARKET UNWORKABLE.

ANOTHER IMPORTANT CONSIDERATION OF THE COMMISSION'S TIERED BILLING PROPOSAL IS THAT THE BENEFICIARIES OF THE PRE-NGPA GAS WILL BE THE ACTUAL CONSUMERS OF GAS -- NOT PIPELINES, PRODUCERS OR DISTRIBUTORS. THE SEPARATION OF THIS GAS IN THE PIPELINE'S BILLING PROCEDURES WILL PREVENT ANYONE BUT CUSTOMERS FROM CAPTURING THE ECONOMIC BENEFITS ASSOCIATED WITH LOW COST, PRE-NGPA GAS.

HOW SIGNIFICANT ARE THE BENEFITS? IN MY OPINION, THEY ARE SUBSTANTIAL. IN THE CASE OF MICHCON AND ITS CUSTOMERS, THE SAVINGS ATTRIBUTABLE TO THE COMMISSION'S PROPOSAL, SHOULD IT BE IMPLEMENTED IN ITS ENTIRETY, COULD AMOUNT TO $250 MILLION IN THE FIRST YEAR. THAT'S ABOUT $150 FOR OUR TYPICAL CUSTOMER, AND COULD REDUCE THE ESTIMATED 1986 GAS BILL FROM APPROXIMATELY $1,000 TO $850.

IT IS MY OPINION THAT THIS IS JUST TOO GREAT A SAVINGS TO IGNORE IN ORDER TO PAY FOR THE MAINTENANCE OF THE STATUS QUO AND THE ASSURANCE THAT WE WILL ALWAYS HAVE A GAS SURPLUS. LOW-COST NATURAL GAS SUPPLIES SHOULD BE DELIVERED NOW AT A PRICE THAT BENEFITS CUSTOMERS AND MEETS COMPETITION.

AT THE SAME TIME, ALL GAS CUSTOMERS CAN BE EXPECTED TO BENEFIT FROM THE COMPETITIVE STIMULUS THAT WILL EXIST FROM MARKET-RESPONSIVE PRICING OF NEW, INCREMENTAL GAS SUPPLIES. THIS FERC RULE WOULD PROVIDE THE CLOSE RELATIONSHIP TO THE MARKET WHICH IS ESSENTIAL FOR LONG-TERM INDUSTRY BALANCE.

A SECOND IMPORTANT ELEMENT IN THE COMMISSION'S PROPOSED RULEMAKING IS TO PROVIDE FOR NON-DISCRIMINATORY ACCESS TO TRANSPORTATION ON ANY PIPELINE THAT OFFERS ITSELF AS A TRANSPORTER OF GAS FOR OTHERS. A KEY REQUIREMENT FOR THIS TRANSPORTATION PROGRAM IS THAT THE TRANSPORTING PIPELINE'S CURRENT SALES CUSTOMERS, MOST OF WHOM ARE DISTRIBUTION COMPANIES, COULD, OVER A FOUR-YEAR PERIOD, REDUCE THOSE CONTRACTS OR CONVERT THEM INTO TRANSPORTATION CONTRACTS.

THE COMMISSION WOULD NOT ALLOW PIPELINES TO REALLOCATE UNRECOVERED COSTS WHEN CUSTOMERS REDUCED THEIR CONTRACTS, AS HAS BEEN THE PRACTICE. PIPELINES WOULD BE FORCED TO SEEK NEW CUSTOMERS FOR THEIR EXCESS CAPACITY, RATHER THAN INCREASING THE COSTS ASSIGNED TO REMAINING CUSTOMERS.

SINCE PRICE COMPETITION WOULD EXIST AMONG PIPELINES FOR TRANSPORTATION SERVICES, AND ONLY BY INCREASING THROUGHPUT COULD PIPELINES INCREASE THEIR PROFITS, THE COMMISSION'S PROPOSAL WOULD ENSURE THAT TRANSPORTATION RATES WOULD ENCOURAGE THE TRANSPORTATION AND SALE OF GAS OTHER THAN THE PIPELINE'S OWN. ANY PIPELINE THAT IS ABLE TO EFFICIENTLY UTILIZE ITS SYSTEM AND MAXIMIZE ITS THROUGHPUT SHOULD BE ABLE TO PROSPER IN THIS NEW COMPETITIVE ENVIRONMENT.

MICHCON BELIEVES THAT THE COMMISSION'S PROPOSED TRANSPORTATION RULES WOULD OPEN UP ACCESS TO THE SPOT MARKET, PROVIDE DISTRIBUTION COMPANIES WITH THE OPPORTUNITY TO PURCHASE THE LOWEST COST GAS AVAILABLE AND PLACE COMPETITIVE PRESSURE ON THE PIPELINES' OWN GAS PURCHASES. PIPELINES THAT AGREE TO PARTICIPATE IN THE PROGRAM WILL HAVE AN OPPORTUNITY TO MAKE PROFITS THROUGH THE TRANSPORTATION OF MARKETABLE GAS AND PRODUCERS OF SHUT-IN MARKET-PRICED GAS WOULD HAVE A WAY TO GET THAT GAS TO MARKET. THESE ARE ALL ESSENTIAL COMPONENTS OF THE COMPETITIVE ENVIRONMENT WE NEED IF WE ARE TO BRING ABOUT LONG TERM BALANCE IN THE GAS INDUSTRY.

IN CONCLUSION, I BELIEVE WE MUST ACT NOW TO ABOLISH CURRENT REGULATIONS THAT ARE OUT OF STEP WITH THE COMPETITIVE ENVIRONMENT THAT HAS EMERGED IN THE NATURAL GAS INDUSTRY. AT LONG LAST, DISTRIBUTORS NOW HAVE AN OPPORTUNITY TO COMPETE ON A "LEVEL PLAYING FIELD" WITH PIPELINE COMPANIES AND PRODUCERS FOR LOW-COST NATURAL GAS. THIS OPPORTUNITY IS LONG OVERDUE AND OF IMMENSE VALUE TO NATURAL GAS CUSTOMERS. WE MUST NOT ALLOW IT TO ESCAPE.

Senator NICKLES. Mr. Stewart, thank you very much.

Mr. Honeyman.

STATEMENT OF CRAIG S. HONEYMAN, MANAGER, ECONOMIC DEVELOPMENT, NORTHWEST NATURAL GAS CO.

Mr. HONEYMAN. Thank you. My name is Craig Honeyman. I represent Northwest Natural Gas Co., a local distribution utility in Portland, OR.

Mr. Chairman, I'm grateful for the opportunity to appear before you today to discuss an issue relating to the FERC's proposed rule that is of critical importance to Northwest Natural. The rule addresses a number of issues affecting the entire natural gas industry from producers to end users, but I would like to focus your attention today on part C of the NOPR relating to optional expedited certificates.

In the interest of time, I will skip the background that I was going to give you on my company, but for reference, for perspective, let me point out that in 1984 industrial sales made up 56 percent of total sales and 50 percent of total gas revenues. Northwest Natural depends upon one pipeline supply system for delivery of all of its natural gas. That system is owned and operated by Northwest Pipeline Co., no affiliation to my company. We are the largest local distribution company on that system.

The proposition I want to put forth for your consideration today is that part C of the NOPR relating to expedited certificates is predicated upon a competitive situation that exists in many portions of the country, especially larger urban areas served by multiple pipeline suppliers, a situation which does not exist in service territories such as that served by Northwest Natural Gas Co.

Consequently, a generic rule on expedited certificates may not serve the public interest in every instance. Deregulation of the natural gas industry where competition exists is certainly a laudatory goal; however, deregulation where a monopoly exists may not bring about the desired results.

Oregon and Washington both allocate exclusive or certificated territories to local distribution companies serving those States. Traditionally, service to end users has been provided by local distribution company customers of a pipeline supplier such as Northwest Pipeline. However, the proximity of many large industrial plants in the region to Northwest Pipeline's transmission lines could result in wholesale flight from traditional utility end user relationships in favor of direct purchases or transportation services from the pipeline supplier.

This would be a direct challenge to the legal authority of the States to regulate natural gas sales and transportation for local consumption. Service by LDC's focuses accountability upon the local utility and assures that all retail customers, residential, commercial, and industrial alike, benefit from competitive market conditions.

The existing structure of the natural gas industry is a procompetitive structure which provides maximum safeguards or protections to consumers. The specialization of producers, pipelines and LDC's promotes efficiency and minimizes the total cost of natural gas service.

Northwest Natural is particularly concerned about the potential for bypass for three reasons. First, as I have already pointed out, we operate in a single pipeline area. During FERC hearings on the NOPR it was suggested that distributor bypass would not be a significant problem because pipelines would be preoccupied in competing with each other for the LDCs' business and the resulting lower gas prices would allow LDC's to provide competitive prices to all end users.

While this may certainly happen in multiple pipeline areas, this market condition will not occur in the Pacific Northwest. In fact, there may be every incentive for pipelines to compete with current or former LDC sales customers for service to the cream of the industrial end user market. In short, in a single pipeline area, the NOPR would strengthen a pipeline's natural monopoly rather than stimulate competition.

The company's second major concern is the impact expedited certificates will have on LDC customers, particularly in the residential and commercial classes who cannot negotiate a bypass agreement. Loss of industrial load would require a reallocation of the company's fixed costs among its remaining customer base. The obvious result would be higher rates for residential and commercial customers.

The contribution that Northwest Natural's industrial customers have made to fixed-cost coverage has helped keep residential and commercial gas rates reasonable and competitive in a region that in the last 12 years has experienced relatively high gas costs and very low competitive fuel costs.

Third, we are concerned because the NOPR comes at a time when Northwest Natural and many other LDC's in the region are responding successfully to competitive pressures using traditional market-responsive mechanisms. We offer, for example, a flexible interruptible rate schedule which is adjusted monthly based upon the local price of residual oil. This has made it possible to sign several of our largest industrial customers to new long-term contracts.

It is therefore not correct to assume that traditional market mechanisms are not responding and cannot respond to pressures for reasonably priced sales and transportation services to local large industrial end users. We have urged the FERC in written and oral testimony to confirm its longstanding policy in favor of service to all local end users by LDC's rather than interstate pipelines.

In keeping with this recommendation, Northwest Natural has proposed during the FERC proceedings the adoption of an amendment to the proposed rule to clarify that the full procedural requirements of section 7 of the Natural Gas Act, including the applicant's burden of proof, apply to any proposal for direct sales or transportation services to end users where the relevant market area is served by only one interstate pipeline. A copy of this amendment appears at the end of my written testimony.

Adoption of this amendment would allow the new rules to operate so as to achieve many of the FERC's objectives without creating chaos in the local distribution and regulation of natural gas service.

In conclusion, we are satisfied that FERC is adequately addressing the concerns raised by our testimony and are hopeful that they will include the amendment in the final rule.

Thank you very much.

[The prepared statement of Mr. Honeyman follows:]

TESTIMONY OF CRAIG S. HONEYMAN, MANAGER OF ECONOMIC DEVELOPMENT, NORTHWEST NATURAL GAS COMPANY, PORTLAND, OREGON, BEFORE THE SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION OF THE SENATE ENERGY AND NATURAL RESOURCES COMMITTEE ON THE FEDERAL ENERGY REGULATORY COMMISSION'S NOPR AFFECTING THE REGULATION OF NATURAL GAS PIPELINES AFTER PARTIAL WELLHEAD DECONTROL (RM85-1-000).

SEPTEMBER 19, 1985

Mr. Chairman and members of the subcommittee, I am grateful for the opportunity to appear before you today to discuss an issue relating to the Federal Energy Regulatory Commission's (FERC) proposed rule that is of critical importance to Northwest Natural Gas Company, a local distribution utility in Portland, Oregon. The rule addresses a number of issues affecting the entire natural gas industry, from producers to end users, but I would like to focus your attention for a moment on Part C of the NOPR, relating to Optional, Expedited Certificates.

In order to establish a frame of reference, however, let me give you a brief description of Northwest Natural Gas Company and how we fit into the natural gas picture in the Pacific Northwest. Northwest Natural is the largest local distribution company (LDC) in the region. Our exclusive service territory includes 17 Oregon and three Washington counties; covers approximately 15,000 square miles of northwest Oregon and southwest Washington; and contains a substantial part of the population of Oregon and southwest Washington. Our operations are regulated by the Public Utility Commissioner of Oregon and the Washington Utilities and Transportation Commission. The company serves some 258,000 customers in the two states. Of these, about 227,000 are residential customers, 30,000 are commercial customers, 373 are industrial firm customers, and 201 are industrial interruptible customers. In 1984, industrial sales made up 56 percent of total sales and 50 percent of total gas revenues.

Northwest Natural depends on one pipeline supply system for delivery of all its natural gas -- the system owned and operated by Northwest Pipeline Company (no affiliation). We are the largest local distribution company on that system.

Approximately 55 percent of the pipeline's gas supplies are domestic, produced from the San Juan Basin in New Mexico, the Big Piney Basin in Wyoming, and various other Rocky Mountain gas fields. The remaining 45 percent comes from the Canadian provinces of British Columbia and Alberta.

The proposition I put forth for your consideration today is that Part C of the NOPR relating to expedited certificates is predicated upon a competitive situation that exists in many portions of the country, especially larger urban areas, served by multiple pipeline suppliers, but which does not exist in service areas such as that served by Northwest Natural Gas Company. Consequently, a generic rule on expedited certificates may not serve the public interest in every instance. Deregulation of the natural gas industry where competition exists is a laudatory goal. Deregulation where a monopoly exists may not bring about the desired results. In fact, the FERC's proposed expedited certificate procedure will undoubtedly result in attempts at unwarranted, and perhaps even unlawful, bypasses of local distribution companies' services and state utility commission jurisdiction.

Oregon and Washington both allocate exclusive or certificated territories to the LDCs serving these states. Traditionally, service to end users has been provided by local distribution company customers of a pipeline supplier, such as Northwest Pipeline. However, the proximity of many large industrial plants in the region to Northwest Pipeline's transmission lines could result in wholesale flight from traditional utility/end user relationships in favor of direct purchases or transportation services from the pipeline supplier. This, in turn, could give rise to years of litigation involving end users, LDCs, pipelines, and state commissions. An "easy bypass" rule would be a direct challenge to the legal authority of the states to regulate natural gas sales and transportation for local consumption.

Service by LDCs focuses accountability on the local utility and assures that all retail customers benefit from competitive market conditions. The existing structure of the natural gas industry is a pro-competitive structure which provides maximum safeguards and protections to consumers. It also provides significant economies and efficiencies in the provision of natural gas service to consumers. Pipelines purchase natural gas from producers and others. They have expertise in acquiring gas supplies and in designing and operating their systems to serve their customers' needs. LDCs, in turn, have expertise in selling natural gas in their market areas and in adapting their sales practices to the needs of the marketplace. The specialization of producers, pipelines, and local distribution companies promotes efficiency and minimizes the total cost of natural gas service. The need for continued exploration for long-term supplies, a necessary component of a stable natural gas industry, is not served by a system that allows short-term spot market purchases and expedited transportation service outside of traditional market mechanisms.

Northwest Natural Gas Company is particularly concerned about the potential for bypass for three reasons. First, as I have already pointed out, we operate in a single pipeline area. The same is true of all other LDCs on the Northwest Pipeline system. During FERC hearings on the NOPR, it was sugggested that distributer bypass will not be a significant problem, because pipelines will be preoccupied competing with each other for the LDCs' business, and the resulting lower gas prices will allow LDCs to provide competitive prices to all end users. While this may happen in multiple pipeline areas, this market condition will not occur in the Pacific Northwest. In fact, there may be every incentive for pipelines to compete with current or former LDC sales customers for service to the cream of the industrial end user market. In short, in a single pipeline area, the NOPR would strengthen a pipeline's natural monopoly rather than stimulate competition. The winners would be the pipeline, with a chance to increase throughput at no loss of margin, and the select few large end users with an opportunity to achieve some short-term fuel cost savings at the expense of other LDC core-market customers.

This brings me to the company's second major concern: the impact expedited certificates will have on LDC customers, particularly in the residential and commercial classes, who cannot negotiate a bypass arrangement. Loss of industrial load would require the reallocation of the company's fixed costs among its remaining customer base. The obvious result would be higher rates for residential and commercial customers. The contribution that Northwest Natural's industrial customers has made to fixed cost coverage has helped keep residential and commercial gas rates reasonable and competitive in a region that, in the last 12 years, has experienced relatively high gas costs and very low competitive fuel costs.

Third, we are concerned because the NOPR comes at a time when Northwest Natural Gas Company and many other LDCs in the region are responding successfully to competitive pressures using traditional market-responsive mechanisms. We offer a flexible interruptible rate, which is adjusted monthly based upon the local price of residual oil. This has made it possible to sign several of our largest industrial customers to new long-term contracts, contributing to economic stability at a time when jobs, particularly in the wood products industry, are being lost almost on a daily basis. It is, therefore, not correct to assume that traditional mechanisms are not responding, and cannot respond, to market pressures for reasonably priced sales and transportation services to large industrial end users. At Northwest Natural Gas, we have been doing it for years. The "easy bypass" scenario contemplated in the NOPR would negate these efforts.

We submit that there is no legal, economic, or public interest justification for eliminating or eroding a competitive position developed over many years of prudent management. We have urged FERC in written and oral testimony to confirm its long-standing policy in favor of service to all local end users by LDCs rather than by interstate pipelines.

Finally, in keeping with this recommendation, Northwest Natural has proposed the adoption of an amendment to the proposed rule to clarify that the full procedural requirements of Section 7 of the Natural Gas Act, including the applicant's burden of proof, apply to any proposal for direct sales or transportation services to end users where the relevant market area is served by only one interstate pipeline. A copy of this amendment appears at the end of my written testimony. Adoption of this amendment would allow the new rules to operate so as to achieve many of the FERC's objectives, without creating chaos in the local distribution and regulation of natural gas service. We are satisfied that the FERC is adequately addressing the concerns raised by our testimony and are hopeful that the amendment will be included in the final rule.

In conclusion, let me remind you of the situation in the telephone industry where higher rates for residential and small users have resulted as large users have left the traditional carrier system or paid less than full cost for services. We submit that this NOPR, at least as it pertains to expedited certificates, is taking us in the same direction -- higher rates for the smaller user.

F.E.R.C. Docket No. RM85-1

PROPOSED AMENDMENT
TO CFR TITLE 18, PART 157
SECTION 157.104

§157.104 Hearings.

(a) General. ***

(b) Presumption. ***

(c) Rebuttal of Presumption. ***

[NEW] (d) Exception.

No presumption will arise under paragraph (b), and an applicant shall be required to satisfy all of the provisions of section 7(e) of the Natural Gas Act, if the application is to provide new services as defined in §157.100 to an end user, and the new services are to be provided by a natural gas company in a market area where a local distribution company providing or potentially providing service to the end user is served by only one natural gas company. In determining whether a proposed new service, sale, operation, construction, extension, or acquisition under these circumstances is or will be required by the present or future public convenience and necessity, the Commission will presume that sales or transportation service by local distribution companies is in the public interest because the sale and distribution of natural gas to local consumers is essentially local in aspect and is subject to state regulation.

Senator NICKLES. Mr. Honeyman, thank you very much.

Mr. Vlcek.

STATEMENT OF JAN VLCEK, COUNSEL, PROCESS GAS CONSUMERS GROUP

Mr. VLCEK. Thank you, Mr. Chairman. I am Jan Vlcek, counsel to the Process Gas Consumers Group. I am appearing here today for Jack Elam and I apologize to you, Mr. Chairman. He was unavoidably called back to North Carolina. I ask that his full statement be put in the record, and I will briefly summarize.

Senator NICKLES. Certainly.

Mr. VLCEK. When PGC last appeared before your committee in July our statement identified nondiscriminatory transportation as the only means left to rectify the problems of the natural gas market and cited examples of interstate pipelines and local distribution companies erecting barriers to such transportation.

Because of FERC's action to eliminate such discriminatory transportation, we commend the Commission for its thorough investigation of the problems of the natural gas industry and its comprehensive proposal to address those problems. We believe, however, the proposal can be improved and particularly, as we have told the Commission, we believe part D is seriously defective and should be abandoned or significantly modified.

We do, however, believe that it is absolutely necessary that the part A blanket transportation and part C optional certificate provisions be implemented well before the October 31 expiration of the order 234B blanket transportation program. We agree with FERC that the present regulatory system is inadequate to serve the public interest and therefore must be changed. As demonstrated by recent experience and recognized by the NOPR, existing patterns of regulation and industry behavior do not efficiently balance supply and demand or minimize gas costs for consumers.

Constructive change is necessary. We strongly support the general thrust of parts A and C and have suggested in our comments to the Commission several improvements. For example, first the proposed rule should require participating pipelines to offer interruptable transportation as well as firm. Second, we are concerned that the volumetric rate design proposal for firm transportation will cause customers to reserve more capacity than they actually require. To avoid this problem, we have recommended a reservation demand charge.

Third and most important, Mr. Chairman, we are also concerned that unless downstream pipelines and distributors have some incentive to provide nondiscriminatory transportation also, nondiscriminatory transportation by upstream pipelines under the proposal would be meaningless. We have recommended that the proposed rule be modified to restrict the rule's benefits to those downstream pipelines and distributors that in turn offer nondiscriminatory transportation.

And, of course, distributors who refuse to provide nondiscriminatory transportation should be exposed to the possibility of being bypassed. There's been a lot of talk here this morning about bypass, and I would just like to offer a few comments on that, if I may, which aren't necessarily in our testimony.

First, on behalf of Bethlehem Steel, the McKenzie Co. did a report, which I would like to have inserted in the record, if we may, which indicated that the catastrophic consequences of bypass are substantially exaggerated, that indeed in the first place the majority of industry users would prefer to work with their local distribution company so long as we receive reasonable rates and a wide range of services, and we have so indicated.

Second, even if bypass were to occur, in the majority of cases, as the McKenzie report indicates, distribution of fixed costs among remaining classes would not necessarily be the large problem because the majority of costs are gas costs. And third, and finally, as we indicated in comments that we made to the Federal Energy Regulatory Commission, this is not a risk-free proposition and indeed we think that the local distribution companies should share some of the risk of the new market conditions.

In sum, Mr. Chairman, PGC is convinced that part A and C of the NOPR would result in an operationally workable system. We have provided to your staff copies of our comments which answer your question about legal authorities, appendix G appended thereto. We have spent an awful lot of time about that and I won't get into that at this point. Suffice it to say that we believe that indeed the Commission does have the authority under the Natural Gas Act to do what they've done, in part A particularly.

Although it's unlikely that any regulatory system can assure consumers a reliable long-term supply of gas at lowest possible price, we think that NOPR takes a positive step toward achieving this goal. By introducing competitive market discipline in the natural gas market. By providing fair access to competitively priced gas for all consumers, the proposed rule should facilitate the lowest reasonable rates.

In summary, Mr. Chairman, the notice represents a timely and generally well thought out attempt to address the current problems of the industry. PGC strongly supports the Commission's attempt in parts B and C to introduce additional competition and we believe that it's imperative that these provisions be implemented well before October 31 of this year.

We believe that block pricing is inappropriate. It should either be abandoned or replaced by other alternate proposals that we have made, which are similar to other proposals you have heard this morning.

Finally, we are not convinced that part B is necessary. We have also suggested several modifications which are necessary to make that workable, and this concludes our prepared statement.

[The prepared statement of Mr. Elam follows:]

BEFORE THE
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

STATEMENT OF THE PROCESS GAS CONSUMERS GROUP

I am Jack Elam, Vice President and General Counsel of Cone Mills Company and Chairman of the Process Gas Consumers Group.

The Process Gas Consumers Group (PGC) is an organization of nineteen large industrial consumers of natural gas organized to promote the development and adoption of coordinated, rational, and consistent federal and state policies with respect to gas use. Representing many of the nation's basic industries, our member companies own and operate hundreds of plants in virtually every state and purchase natural gas directly or indirectly from both interstate and intrastate pipelines, with most of our facilities on the interstate system. A list of our members is included as Attachment 1.

PGC appreciates this opportunity to offer its views on the Federal Energy Regulatory Commission's Notice of Proposed Rulemaking concerning the regulation of natural gas pipelines after partial wellhead decontrol, Docket No. RM85-1-000.

I. PGC's Perspective

PGC members consume natural gas in many applications but our statement today reflects primarily our use of natural gas in industrial processes for which alternate, non-gaseous fuels cannot economically or technically be utilized. From our perspective, there are two paramount natural gas issues: (1) security of supply and (2) price. Security of supply, meaning the ability of consumers to depend upon their suppliers to satisfy their gas requirements, is vital to us because uncertain natural gas supplies could threaten our ability to operate our facilities. Natural gas prices are a major concern because, as with other inputs into the manufacturing process, these costs must be recovered in the prices we charge for our products. As consumers operating in competitive national and international markets, we cannot tolerate the impact of artificially high gas prices on our businesses.

PGC last appeared before this Committee on July 11, 1985. At that time, we expressed our concerns about the natural gas marketplace and offered general comments on the Notice of Proposed Rulemaking (NOPR) issued on May 30 by the Federal Energy Regulatory Commission ("Commission"). Our statement identified non-discriminatory transportation as the only means left to rectify the problems of the natural gas market and cited examples of interstate pipelines and local distribution companies erecting barriers to transportation. PGC offered general comments on the NOPR and indicated our general satisfaction with the proposal.

Since we last testified before the Committee, the Commission has received in excess of 6,300 pages of written testimony on the NOPR from more than 275 parties, including PGC. This testimony was supplemented by oral testimony before the Commissioners by 113 parties.

II. The FERC Notice Of Proposed Rulemaking

Prior to addressing specific provisions of the NOPR, several general comments are in order. First, we commend the Commission for its thorough investigation of the problems in the natural gas industry and its comprehensive proposal to address those problems. The proposed rule is a direct outgrowth of FERC's extensive three-phase Notice of Inquiry proceeding in Docket No. RM85-1-000, which was initiated by notices issued December 24, 1984 and January 18, 1985 and on which substantial written and oral comments were presented by a variety of interested parties. Moreover, the NOPR is responsive to the urgent need for a self-help transportation program following the recent decisions of the United States Court of Appeals for the D. C. Circuit which vacated portions of FERC blanket certificate and special marketing programs.

Second, although PGC strongly supports the Commission's attempt to aggressively attack some of the problems present in the natural gas industry, we do not agree with the proposal in its entirety. In particular, we believe that Part D is seriously defective and should be abandoned or significantly modified. Moreover, while we agree that the Commission should permit prudently incurred take-or-pay expenditures to be included in pipelines' rates, we are not convinced that Part B's "safe harbor" proposal is necessary.

Third, given the number (and extensiveness) of written comments and oral presentations by parties representing the full spectrum of the natural gas industry, it is fair to assume that the views of every interest group have been fully aired. However, as with any significant proposal, some parties undoubtedly will be dissatisfied with the Commission's actions and therefore will seek to delay and defeat the proposal. PGC strongly believes that delayed implementation of the NOPR will serve no useful end and, indeed, will be counterproductive. Even if additional consideration may be necessary for those portions of the NOPR which are most controversial -- the Part B take-or-pay safe-harbor proposal and the Part D block pricing provisions -- PGC believes it is absolutely necessary that the Part A blanket transportation and Part C optional certificate provisions be implemented well before the October 31 expiration of the Order 234-B blanket transportation program.

III. The Present Regulatory System Does Not Serve The Public Interest Well And It Must Be Changed.

PGC agrees with FERC that the present regulatory system is inadequate to serve the public interest and therefore must be changed. A large body of evidence from many sources demonstrates that the existing natural gas system operates in many ways that are harmful to the overall public interest and to the interests of captive gas consumers, producers and local distribution companies. As demonstrated by recent experience and recognized by the NOPR, existing patterns of regulation and industry behavior do not efficiently balance supply and demand or minimize gas costs for consumers. Moreover, recent experience has also demonstrated what both common sense and economic theory suggest: customers with viable supply options will almost inevitably receive lower priced supplies and better service than captive customers. To verify this conclusion, one need only look to the proliferation of discount programs and selective transportation patterns provided by pipelines to consumers with alternate fuel sources.

The detrimental impact of current regulations has not been limited to consumers; rather, all sectors of the natural gas industry have been adversely affected by the significant load losses caused by above-market prices. Producers of new gas in particular have been affected because many pipelines have stopped buying gas in recent years. Direct sales markets have thus become the only outlet for many producers of new gas and a major stimulant for drilling and exploration to discover the reserves that will be needed to serve all consumers in the long run. However, to the extent that pipelines and distributors block transportation or impose discriminatory restrictions, the direct sales market cannot function.

PGC believes that constructive change is necessary to remedy these problems with the current regulatory system. We believe that the NOPR correctly recognizes that the development of a workably competitive market is essential to the long term health of the natural gas industry and to the nation as a whole. In our view, the key to developing competition is open, non-discriminatory transportation. Our review of the extensive comments on the NOPR reveals that no party has directly disputed the need for non-discriminatory transportation, although many parties have suggested subtle, and some not so subtle, changes that would undermine the concept of non-discriminatory transportation in order to protect the particular party's perceived interest.

PGC strongly supports the general thrust of Parts A and C as providing the needed regulatory change, and we have suggested in our comments to the Commission several improvements that will help the proposed rule achieve its stated goals. For example:

o The proposed rule would require participating pipelines to offer firm transportation only. Because we are concerned that capacity restrictions on some pipelines would preclude the availability of firm transportation, we have suggested that _interruptible_ transportation be required as well. There has been widespread agreement on this point by other parties filing comments.

o We are also concerned that the volumetric rate design proposed for _firm_ transportation will cause customers to reserve more capacity than they actually require to meet their needs, as there will be no disincentive for doing so. This will either restrict access to transportation by allowing a few customers to "lock up" all available capacity or, if pipelines are allowed to over-sell capacity, truly "firm" transportation will not be available under the proposed rule. To avoid this problem we have recommended a pure fixed-variable rate design which would include a reservation (demand) charge. A broad consensus on the need to have demand or reservation charges emerged in comments on the NOPR.

o We are also concerned that, unless downstream pipelines and distributors have some incentive to provide non-discriminatory transportation too, non-discriminatory transportation by upstream pipelines under the proposed rule would be meaningless. For example, notwithstanding that a pipeline may be willing and able to provide transportation for an end user, a transaction could be blocked by a recalcitrant distributor. We have recommended that the proposed rule be modified to restrict the rule's benefits to only those downstream pipelines and distributors that in turn offer open, non-discriminatory transportation on their own systems. Of course, to the extent that distributors refuse to provide cost-based non-discriminatory transportation in order to protect their non-competitive sales, they may bring upon themselves the threat of being bypassed. Contrary to the claims of many distributors, industrial consumers are generally not eager to bypass local distribution systems but may be forced to do so by non-competitive distributor rates or the unavailability of distributor transportation at fair rates.

IV. Except For Part D As Currently Proposed, The NOPR Would Generally Create An Operationally Workable And Legally Sound Regulatory System.

PGC is convinced that Parts A and C of the NOPR would result in an operationally workable system. Existing transportation programs, to the extent that they have been permitted to function, have already been shown to be operationally workable. Consolidation of the several existing blanket certificate programs into one single program will simplify transportation procedures.

Conditioning pipeline participation on non-discriminatory transportation will introduce a greater measure of competition into the natural gas industry and thereby impose competitive market discipline. Moreover, additional competition will be introduced by the non-exclusive optional certificates authorizing new service and related facilities.

In contrast, Section D, as proposed, is unworkable and unnecessary. The block billing provisions of Part D, which would eliminate rolled-in pricing in favor of a scheme which would allocate cheaper old gas to existing firm sales customers, are intended to eliminate market distortions caused by prior price controls. We support the goal of eliminating market distortions, but we strongly believe that the block billing proposal will exacerbate and perhaps perpetuate the very market distortions which it is intended to eliminate. The old gas cushions for most pipelines were neutralized by the pipelines' own purchasing practices during the first few years after the enactment of the NGPA. Part D would simply revive those cushions and shift the problems associated with them to the distribution level, thus disadvantaging end-users, pipelines and shallow-cushion distributors. Moreover, price fly-up similar to that experienced after the enactment of the NGPA with respect to deregulated Section 107 gas could be expected because distributors with deep cushions would be able to outbid other entities for new gas supplies and yet remain competitive by rolling in those new supplies with old, cheaper gas. Finally, we are concerned that, to the extent rolled-in pricing is not required at the distributor level, discrimination will occur in the form of cheap gas being allocated to favored customer classes while higher priced gas is allocated to industrial customers. PGC has suggested two potential alternatives to Part D in its comments to the Commission. First, the Commission could reduce the effects of pipeline gas cushions by exercising its authority under NGPA Sections 104, 106 and 109 to establish higher "just and reasonable" prices for these categories. Second, the Commission could permit pipelines to use their rolled-in supplies to sell gas off-system at market prices to willing buyers.

While PGC is not convinced that the Part B take-or-pay safe harbor provisions are necessary, we believe that, if Part B is adopted, certain changes must be made for the proposal to be workable. We generally agree that it is appropriate to permit prudently incurred take-or-pay buyout expenditures to be included in pipelines' rates, but we are concerned that setting a specific ceiling on take-or-pay settlements will in fact establish a floor for pipeline settlements with producers. We have suggested that 10-15% of a pipeline's projected take-or-pay liability for 1986-1987 be presumptively recovered through demand charges and that additional settlement amounts be considered in general rate cases. Moreover, we believe that pipelines should be permitted to release producers from contracts as part of settlements.

In addition to being operationally workable, the proposed non-discriminatory transportation provisions of Part A and the optional certificate provisions of Part C are legally sound.

FERC's authority to adopt such provisions is derived from the Natural Gas Act, which the courts have repeatedly construed to give FERC broad powers. The Natural Gas Act was premised on the notion that limited effective competition existed among interstates and that direct regulation was therefore necessary as a surrogate for competition. Although the Commission may not rely entirely on market forces in lieu of direct regulation, market forces are a proper substitute for direct regulation where viable competition exists.

With specific respect to blanket certificate transportation, the Commission has ample legal authority to implement blanket transportation regulation by rulemaking rather than on a case-by-case basis. In fact, the transportation proposals are well-suited for implementation by rule as a case-by-case approach would take years. Moreover, given the recent decision of the D. C. Circuit, it appears that FERC is compelled to condition blanket transportation programs on the availability of non-discriminatory transportation. We also believe that the optional expedited certificate procedures proposed in Part C are likewise within the Commission's statutory authority, and this conclusion is supported by the legal authorities discussed in Appendix G to the comments which we filed with the Commission in response to the NOPR.

V. The NOPR Would Facilitate The Availability To Consumers Of A Reliable Supply Of Gas At The Lowest Reasonable Cost And Should Stimulate Exploration For New Gas Supplies And Production From Existing Gas Reserves.

Although it is unlikely that any regulatory system can assure consumers a reliable long term supply of gas at the lowest possible price, we believe that the NOPR takes a positive step towards achieving this goal by introducing competitive market discipline in the natural gas market. As security of supply and price are our two main concerns, we do not make this judgment hastily. However, as I mentioned earlier in my remarks, both economic theory and recent experience suggest that, where alternative sources of supply are available, consumers invariably receive better service at lower prices. By providing fair access to competitively priced gas for all consumers, the proposed rule should facilitate the lowest reasonable rates.

While the producer representatives here today are perhaps best able to respond to whether the NOPR will stimulate exploration for new gas supplies, it is our belief that the NOPR will stimulate exploration and development by providing a ready market for new gas supplies and allowing appropriate price signals to travel from the wellhead to the burner-tip. Consumers will receive lower prices when there are ample supplies and a reduced risk of harmful curtailments when supplies are tight. In our comments to the FERC, we suggested that the Commission could deal with the disincentives to efficient production of old reserves by exercising its authority under the NGPA to elevate ceiling prices for Section 104, 106 and 109 gas to more current "just and reasonable" prices.

VI. Conclusion

The FERC Notice of Proposed Rulemaking represents a timely and generally well thought out attempt to address the current problems of the natural gas industry. PGC strongly supports the Commission's attempt in Parts A and C to introduce additional competition into the market place, and we believe that it is imperative that these provisions be implemented well before October 31 of this year. We believe that the block pricing provisions of Part D are inappropriate and should either be abandoned or replaced by our alternative proposals. Finally, we are not yet convinced that Part B is necessary, but we have suggested several modifications which are necessary to make the proposal workable.

This concludes our prepared statement. We would be happy to answer any questions the subcommittee may have.

PGC
PROCESS GAS CONSUMERS GROUP · SUITE 800/1666 K STREET, N.W.
WASHINGTON, D.C. 20006
202 887-3425

PROCESS GAS CONSUMERS GROUP
MEMBERSHIP LIST

Aluminum Company of America

American Can Company

Atlantic Richfield Company

Armco Incorporated

Bethlehem Steel Corporation

Borg-Warner Corporation

Burlington Industries, Inc.

Carpenter Technology Corporation

Chrysler Corporation

Cone Mills Corporation

Corning Glass Works

Diamond Shamrock Chemicals Company

Eaton Corporation

Ford Motor Company

General Motors Corporation

Hershey Foods Corporation

LTV Steel Company

Owens-Corning Fiberglas Corporation

Owens-Illinois, Inc.

Attachment 1

Senator NICKLES. Mr. Vlcek, thank you very much.
Mr. Gooch.

STATEMENT OF GORDON GOOCH, COUNSEL, PETROCHEMICAL ENERGY GROUP

Mr. GOOCH. Thank you, Mr. Chairman.

On behalf of the Petrochemical Energy Group let me say that we have asked the Commission to issue the transportation and blanket certificate with considerable modification to make the access truly nondiscriminatory, and to make the access so that there are no bottlenecks in the system, whether they are distributors or interstate pipelines. But we find no redeeming social value either in the block pricing or the take-or-pay.

The take-or-pay will never succeed until there is a mutuality and the block pricing presents us with stark terror. Our calculation, based on the mid-1985 EIA data, indicates that the current average price nationwide for natural gas is approximately $2.81. Forty-six percent would be block 1 gas, and that would have an average price of $1.53. Fifty-four percent would be block 2 gas, and that would have an average price of $3.92.

The question presented, then, is if the Commission does not intend this regulation to roll back the price of gas, if it is not a regulatory scheme designed to regulate the price of gas at the wellhead, who then will pay the $3.92? To us it seems a threat worse than incremental pricing at its very worst because at least under incremental pricing the Congress selected what would go in block 2 and put limits on it, Congress selected who would pay the block 2 price and put limits on it, and Congress put a cap.

And there is none of those features in the block pricing. It disappears into the State commissions and you have no idea what comes out at the other end.

Now let's look at the other alternative, because the Commission did say that the block 2 pricing, and I quote, "should serve to lower gas prices in the second block and act as a disincentive to imprudent pipeline purchasing practices." That sound very much like saying we are reimposing wellhead price controls because the prices are too high.

Let's look at that in two components. Part of those high prices are those mandated by the Congress. The Congress has itself set the stripper well price. Maybe that was good policy, maybe that was bad policy, but it was set. The Congress also decreed that at a certain point in time certain prices would be deregulated.

You asked for legal challenges. I'm sure one of them will be how can prices that the Commission intends to roll back after the Congress has said in section 601 that they are deemed to be just and reasonable and the pipeline is to flow it through? Now while that may be a legal argument from the standpoint of the industrials, we have to ask if block 2 gas is rolled back just to the average that gas is currently moving today, that implies that producer revenues will be cut 21 percent.

If you're going to roll the price all the way back to the $2.50 or $2.51, as you mentioned, at the top of 104, that implication is that producer revenues will be cut 27 percent. Now we remember curtailments and we don't want to go through curtailments again. We'd like some assurance, some assurance that on the one hand we're not getting incrementally priced to death and be driven to our knees because somehow all the block 2 gas gets sent to us. And, on the other hand, we don't want to see the prices rolled back to a level where we go back into curtailments.

If you don't want to look at the data on a nationwide basis—and we can't look at the data on a nationwide basis because obviously we buy from many pipelines, both intra and interstate—if you look at PEG chart 1, the line in the middle colored red on this chart is what EIA says is the current weighted average cost of gas on the individual interstate pipeline systems.

You can just look at the red line and see what the cushion does. You can see the distortions in the market. You can see the irrationality generated by the different categories of gas. But is the situation improved at all by moving to block pricing? The green and white line would be the block 1, the blue line would be the block 2, and it's no more a level playing field after block 1 and 2 than it was before, and indeed it's worse.

So we would respectfully suggest that this is not the kind of situation where the normal process of judicial review can offer some help. If it's a normal rate case, money can be collected subject to refund, and at some point in time in the future if there's been a reversal people can hopefully be put as close to the status quo as possible. If this rulemaking comes down to the block pricing, and with the take-or-pay in there it becomes chaos and there is no way that a court can restore the status quo to the situation that will result.

[The prepared statement of Mr. Gooch follows:]

The Petrochemical Energy Group
1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006
(202) 452-1880

TESTIMONY
ON BEHALF OF THE
PETROCHEMICAL ENERGY GROUP

Committee on Energy and Natural
Resources
Subcommittee on Energy Regulation
and Conservation
United States Senate

September 19, 1985

Washington, D.C.

Testimony of the
Petrochemical Energy Group
September 19, 1985

My name is Gordon Gooch. I am counsel to the Petrochemical Energy Group ("PEG") and have been asked to present their testimony today. I am accompanied by E. E. Porter, the Chairman of PEG.

PEG appeared before this Subcommittee on July 11, 1985, and expressed its concerns about the rulemaking in Docket No. RM 85-1. During that appearance, four basic questions were brought to your attention:

1. First, is it likely that the problems caused by the cushion of cheap, forever regulated gas will be solved by the simple expedient of transferring the cushion from the control of companies regulated by the federal government to companies controlled by state governments and the creation of a new federal entitlements program? We think the answer to this is no. We have had considerable experience with other federal entitlements programs and they all have been a disaster. And the cushion problem is not solved merely by creating a new federal entitlements program.

2. Second, is it likely that a non-discriminatory firm transportation system open to all shippers will result if priority is given to local distribution companies who, in turn, are not required to offer transportation service in exchange for the benefits of the program, as both inter and

intrastate pipelines are? We think the answer is no and that the non-discriminatory transportation program may be illusory.

3. Third, is it likely that all producers will be willing to give to the pipelines the discretion to shut-in production for the remainder of their delivery obligation, in exchange for a small fraction of projected payments? We think that the answer is no and that the take-or-pay proposal is unlikely to work.

4. Fourth, is it likely that the prospects for a long-term gas supply will improve or at least stay the same? We are in serious doubt about this. We remember curtailments. The NOPR says in one place that the new rate structure "should serve to lower gas prices in the second block." (NOPR at 51.) If this is true, then it will not be because of market forces but rather because of federal regulation.

Subsequent to their July 11 appearance, PEG filed comments and testified before the Commission, further articulating their concerns.

We will address the four questions posed by the Chairman in his letter of September 9, 1985:

1. Would the public interest be better served by retaining the existing regulatory system?

We do not defend the status quo. There is a cushion problem, a take-or-pay problem, and a problem with obtaining non-discriminatory transportation. The proposed solutions may be worse than the status quo. Specifically, PEG has urged the Commission:

a) to adopt the proposal for Transportation and the Optional, Expedited Certificates, amended as proposed in PEG's Comments in order to make the proposal truly non-discriminatory;

b) not to adopt the proposal for the billing mechanism for old gas supplies; and

c) reconsider the take-or-pay proposal in order to provide more options for both pipelines and producers in the search for an equitable solution.

In short, while we do not accept the proposition that RM 85-1 must be an all or nothing solution, on a hypothetical basis we would choose the status quo over the proposed rule, as it was proposed. The reason we cannot accept the hypothesis is that the Commission is under a judicial mandate to address the transportation issues, and the public interest will not be served either by causing the transportation programs to be enjoined nor by enacting block pricing or this form of take-or-pay relief as the price of having some form of transportation available.

2. Would the NOPR create a regulatory system that would be operationally workable and legally sound?

No. Among other problems, the firm transportation proposal is not likely to be "operationally sound" and is very likely to be illusory. There are several reasons for this, among them being:

a) There is no provision which would insure that industrial users, given the opportunity to obtain transportation on interstate pipeline systems, can get the gas to the feedstock, plant protection, or fuel use in the plants. The Commission should require local distribution companies who receive or who transport, sell, or exchange gas pursuant to the proposed regulations accept as a condition that they, too, will provide non-discriminatory firm and interruptible transportation on their own systems.

b) There is no assurance that firm capacity will be available on the interstate pipelines on a year-round basis. If there is little or no such capacity available, then capacity would have to be made available for such a system to work. It is sometimes said that the ability of the local distribution companies to give up all of their claims on the pipelines would supply this capacity, but there are two basic reasons to doubt this assumption:

(1) The Rulemaking itself suggests the possibility that the local distribution companies would be given a preferential right to convert sales to transportation; and

(2) A release of sales obligations does not seem likely. The decisions of the Commission adopting the modified fixed variable method of rate design (*See* Texas Eastern Transmission Corporation Docket No. RP83-35-000 *et al.*, Order on Classification, Allocation and Rate Design, February 13, 1985) and mitigating or eliminating the minimum

commodity bill, (See Transwestern Pipeline Company, Opinion No. 238, Opinion and Order Eliminating Minimum Bills and Establishing a Just and Reasonable Cost Classification, Cost Allocation and Rate Design Methodology, July 1, 1985, and Order No. 380, Docket No. RM83-71-000, May 25, 1984), coupled with the result in RM 85-1, lead to the sincere doubt that any significant release of sales should be anticipated. In sum, the trend toward lowering the capacity reservation charge on a peak day and lowering the commodity charge while imposing, at most, some fixed charges in the minimum commodity bill, likely means that a local distributor will find it economical to hold the interstate pipeline to its full sales obligation while, at the same time, declining to take gas under the contracts and turn instead to transportation. This has two results: the pipeline has to maintain a gas supply greater than necessary to meet true sales requirements, incur new take-or-pay obligations, while other users are denied access to the pipelines for their transportation needs. This is not to challenge either the rate design or the minimum bill decisions; it is to point out that RM 85-1 is not in a vacuum and must be considered in conjunction with other recent significant regulatory changes made by the Commission.

c) Even if transportation capacity is available on an interstate pipeline system and all other problems are overcome, the NOPR does not provide a basis for other than spot transactions, since the service priority is not established. If a long-term gas supply contract cannot be executed because the service is subject to interruption, the firm transportation is indeed illusory. Even spot transportation is somewhat illusory if there is no interruptible service offered.

These problems can be solved or mitigated in the final rule, and thus these comments should be construed as constructive criticism. When block pricing and the take-or-pay solution are to be considered, however, no similar hope is offered. That is because neither the block pricing nor the take-or-pay proposals address the causes of the respective problems.

The "cushion problem" does not go away by the simple expedient of transferring control from the federal government to the state governments. We have had considerable experience with other federal entitlements programs in the energy arena and none lend themselves to a recommendation. Chart One, attached to our previous testimony on this NOPR, dramatically indicates that the cushion problem becomes even more acute under block pricing.

The "take-or-pay" problem is actually made worse by RM 85-1 in both the block pricing and in the transportation sections while the proposed solution appears to have found few defenders. A "workable" take-or-pay solution would include, as a necessary ingredient, the opportunity to secure a release of reserves from all federal allocation controls, both under the Natural Gas Act and the NGPA.

The second aspect of the question deals with whether the regulatory system is "legally sound." In order to be responsive to this question, PEG has authorized me to present my personal opinion, reserving to PEG the issues which it may wish to present to a Court of Appeals, should that step become necessary. While many of the legal problems are obvious and will undoubtedly be explored in detail by others, there are two which I believe most merit the consideration of an oversight committee, and thus I respectfully tender these observations from a legal viewpoint.

Block pricing is inconsistent with the guaranteed pass-through provisions of the NGPA. Section 601, in summary, declares that interstate pipelines are entitled to recover just and reasonable prices paid for natural gas and that deregulated gas and gas selling at the price established for regulated gas is deemed just and reasonable. The block two pricing regulation directly undercuts that provision. As to regulated gas, that falls into three convenient categories: the flowing gas included in block one, the new drilling to be encouraged for exploration and development and the incentive categories, such as stripper wells, where the Congress established or allows the Commission to establish an incentive price in order to encourage particular activities. The latter two are consigned to block two, as is deregulated gas. In the Commission's own words, the new rate structure "should serve to lower gas prices in the second block and act as a disincentive to imprudent pipeline purchasing practices." (NOPR at 51.) However otherwise characterized, the result is to impede the pass-through of costs which the Congress has deemed to be just and reasonable.

Block pricing is inconsistent with incremental pricing under Title II of the NGPA. Block pricing and incremental pricing have the same basic mechanism: to isolate portions of the purchased gas costs of the interstate pipeline companies for separate billing treatment. But, in incremental pricing, the Congress carefully selected the gas costs to be isolated, carefully selected the "users" who would be incrementally priced, and carefully established a mechanism to make sure that the incrementally priced user would not be called upon to pay a price above the Btu equivalent of alternate fuel, supplemented by an exemption process. The block pricing scheme is inconsistent with these limitations in all material respects.

3. Would the NOPR create a regulatory system that would assure residential, commercial and industrial consumers a reliable long-term supply of natural gas at the lowest possible cost?

We must answer this question in the negative. While we would hope to be wrong in this forecast, the fact that neither the cushion problem nor the take-or-pay problem would be "solved"--and, in fact, might be made worse--coupled with the uncertainties which must follow as implementation of the rule is attempted, not only at the federal level, but in each state, no consumer would be assured of a long-term supply of natural gas at the lowest possible cost, particularly when question four is considered.

First and foremost, the mere promulgation of this Rule is very likely to precipitate a chaos which would defy the protection that judicial review is supposed to afford. In a normal regulatory case, where money is the issue, safeguards can be placed in order to restore the parties to the status quo or close to the status quo in the event that a court reverses the Commission. Not so in this case.

4. What impact would the regulatory system the NOPR proposes to create have on exploration for new gas supplies, and production from existing gas reserves?

This is consistent with the question that PEG asked the Commission to address in our Comments in this NOPR. It does appear to us that the Commission's proposed block pricing and entitlements program will affect the price at the wellhead of both regulated and deregulated gas. This effect is not the result of the free market, but rather is the result of a change in federal regulation.

Because in the past, federal regulations affecting the price of gas at the wellhead have led to curtailments, PEG feels justified in asking the Commission whether long-term gas supply will be adversely affected by this change in federal regulation.

Examination of recent data available from the Energy Information Administration ("EIA") raises questions of concern.

EIA compilations would indicate that, in mid-1985, the price of gas being sold for resale in interstate commerce is approximately $2.81 on a nationwide basis. If the block pricing were in place, then the block one price would be $1.53 and the block two price would be $3.92. In tabular form:

	Mid-85	Volume	Price
	Status Quo	100%	$2.81
RM 85-1			
	Block One	46%	$1.53
	Block Two	54%	$3.92

If the Commission intends to drive the price of block two gas down to the average price of $2.81, then the implication is that the producer revenues will be cut by approximately 21%. If the Commission intends to drive the price of block two gas down to the top level of block one gas--about $2.50--, then the implication is that the producer revenues will be cut by approximately 27%. Will reductions in those orders of magnitude adversely affect the search for and development of new gas supplies? Or, if the Commission does not intend to drive down the price of block two gas at all, who will pay the $3.92? If that gas is simply shut-in, in whole or in part, who will pay any resulting take-or-pay charges?

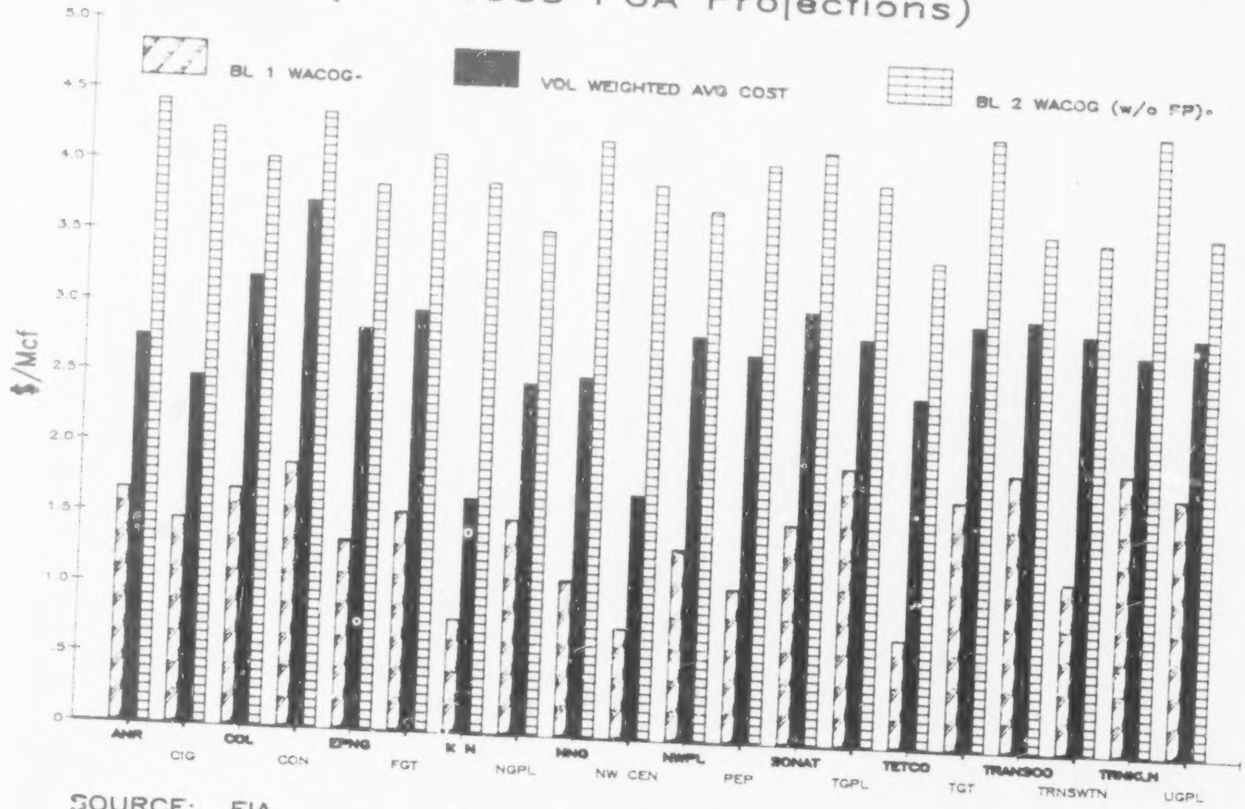
Further, the EIA data indicate that the top twenty producers account for 58% of the volumes being sold in interstate commerce in mid-85. However, if block pricing were in effect, then the top twenty producers would have 70% of the block one volumes but only 48% of the block two volumes. This suggests that any rollback of block two prices as a result of the Commission's action would fall disproportionately on the smaller producers.

We cannot help but be alarmed at the report of the EIA that "During 1984, proved reserves of dry natural gas reached the lowest level in the history of the EIA's estimates." (Advance Summary of the U.S. Crude Oil, Natural Gas, and Natural Gas Liquids Reserves: 1984 Annual Report, EIA, September, 1985.)

We remember curtailments. We do not wish to contemplate ever again suffering through a situation where short-sighted price regulation artificially stifled gas supply.

We appreciate the opportunity to be heard, and we will be pleased to respond to questions.

AVERAGE COST OF WELLHEAD PURCHASES
(Mid-1985 PGA Projections)



SOURCE: EIA

*As defined in RM85-1

PEG CHART 1

Senator NICKLES. Mr. Gooch, thank you for your comment and also for the chart that you provided for the committee.

Mr. Gooch and Mr. Vlcek you represent major gas buyers, I guess—I don't know exactly what percent, but substantial gas buyers. And I heard both of you say that you are opposed to the block pricing system basically because of, one, the inequities. It's perpetuating inequities. I am assuming you would have some people that you represent that would be in block 1 and some would be in block 2 and you may have competitors that might in that way, and one might have a substantial price advantage.

I'm thinking in your group if you are looking at an ammonia producer or fertilizer producer or something like that where gas is a major substantial portion of their cost, if they are fortunate enough to be on block 1, they're in business. If they're on block 2, they have just been put out of business.

Mr. GOOCH. Yes, sir, that is correct. From State to State you will not be able—at least now the Federal Government has the ability to use some effort on an individual pipeline system to address the cushion problem. Once you give that away, once you give away to certain selected customers the block 1, you have no idea who gets that. It passes from Federal control and you just cannot tell whether it will be incremental pricing in its worst form, status quo, or a wonderful subsidy for somebody.

Mr. VLCEK. Essentially, Mr. Chairman, what you're doing is passing the problem on down to the State public utility commissions.

Senator NICKLES. Mr. Stewart, you came out in support of the NOPR, including the block billing and including—or against the transportation?

Mr. STEWART. No, in favor of both.

Senator NICKLES. You're unique to today's hearing.

Mr. STEWART. I'm probably unique in the country. But I'm not crazy. [Laughter.]

Senator NICKLES. I'm glad we don't ask that question of Senators.

Michigan Consolidated Gas is the company that you are representing and are chairman of. You are chairman of Primark, which owns Michigan Consolidated. Would they receive a substantial portion of block 1?

Mr. STEWART. Yes, we would.

Senator NICKLES. If they received a substantial portion of block 2 and very little block 1, would you favor NOPR's ruling?

Mr. STEWART. Well, I just don't think that's the situation. We've been in the gas business a long time, just like any ammonia plant that's been in the gas business a long time. It's going to be entitled to the block 1 gas, whatever the pipeline has.

I think what my colleagues in the industrial businesses are concerned about are political pressures of a State commission that would try to preserve all the block 1 gas for residential customers. I think that's very, very unlikely because most States are very interested in preserving the industries that are in their State and in fact even competing for more.

Senator NICKLES. I think I also heard you say in your statement that you're interested in a market since the type approach, I guess, for new gas.

Mr. STEWART. Yes.

Senator **Nickles**. But that doesn't quite—a lot of people would say well, why not have a more market-sensitive approach for that old gas.

Mr. **Stewart**. Well, I think a lot of people do, and if we could change the way pipelines are regulated so that they are more sensitive to market conditions and have some risk rather than the current regulatory system that they enjoy, then I would be in favor of deregulating the old gas. I think that's up to the Congress. FERC does not have that choice, as I understand it.

Senator **Nickles**. Well, don't you think that FERC by their block billing is taking that choice away from Congress on the assumption that block 1 is going to be perpetually regulated and locking in that economic advantage that you may happen to have?

Mr. **Stewart**. I wouldn't make that assumption. If Congress wanted to deregulate old gas, I don't see how the FERC could stop that.

Senator **Nickles**. Do you think FERC overstepped its bounds in making the price ruling as far as the block billing?

Mr. **Stewart**. Well, like many here I'm not a lawyer, Senator, so I'm not really qualified to say whether they overstepped their bounds. I do know that FERC has a lot of lawyers and I'm sure they studied that issue pretty carefully.

Senator **Nickles**. I hope they study it a lot more carefully.

Mr. **Stewart**. I am sure they are.

Senator **Nickles**. Let me ask a couple of other questions. Representing AGA, Mr. Reif, I heard you come out—correct me if I'm wrong—the AGA has serious concerns about block billing?

Mr. **Reif**. We have very serious concerns about the block billing as presently proposed, yes.

Senator **Nickles**. Strongly opposed to it?

Mr. **Reif**. Strongly opposed.

Senator **Nickles**. And are you also strongly opposed to the carriage provisions?

Mr. **Reif**. We're strongly opposed to the carriage provisions as presently proposed. Again, we have made suggestions in both the carriage provisions and for the block provisions to make them perhaps more workable.

Senator **Nickles**. But you, like most of our witnesses throughout all of our panels today, agree that there will need to be some type of transportation, whether it be exactly as set out in A and C?

Mr. **Reif**. At the present time there is a great deal of voluntary transportation going on, both at the Federal level and at the State level. We're hauling an awful lot of gas on our system for industrial customers with the approval of the State commission, and our position has been and continues to be both at the distributor level that if the NOPR, the rules come out as presently proposed, then we would favor the existing regulatory framework because we think that this is bad timing.

We think this is the first time in 15 years our industry has begun to see the light at the end of the tunnel, and that is adequate supplies, more than adequate supplies. Canadian gas is now coming down here in major volumes at market-clearing prices. In addition to that, we have falling prices, adequate supplies, and we're moving gas voluntarily and aggressively in all our markets.

All of our customers are doing that, and we think that the decision as to carriage ought to be made by the pipelines and the distributors, who know the system much better than FERC.

If FERC gets into a mandatory system, we're going to have all kinds of regulatory problems with their mandating transmission.

Senator NICKLES. Would you favor some type of a blanket approach that's been suggested by some today—modification of the special marketing orders?

Mr. REIF. I think a blanket approach would be a better way to go, but I think it should again be a voluntary opportunity for transmission which, as I say, most of the responsible distributors and transmission companies are today availing themselves of.

One of the problems we have with the block rate—and I heard Mr. Stewart; I would disagree with him on this—a number of distributors have said I don't particularly care what FERC does with the block rate. We'll roll it in at the State level. And we now know there are a number of sophisticated State commissions who said if we get a signal from FERC to go to a block rate, we will go to a block rate at the State level and we'll reserve the 104 gas for the residential customers.

And if they do that, then they significantly impact the distributor's ability to serve the industrial market, and if they do that we'll move 5 or 6 trillion cubic feet of gas out of the industrial market and move all those fixed charges over on the existing residential and commercial customers.

Senator NICKLES. Just make it that much more expensive?

Mr. REIF. I think if you were to ask the right question, the question that I would pose to all the distributors: If you lose, let's say, 75 percent of your industrial load, what would that impact be on residential and commercial customers throughout the United States? And I think the impact would stagger the imagination of this committee.

Senator NICKLES. There's no doubt about that.

I also appreciate your comment and I wholeheartedly agree with you that there is a significant negative impact on end use restrictions, including in that the Fuel Use Act and incremental pricing. I don't see it as significant as block pricing insofar as being a negative on this industry, but I think the very fact that you have end use restrictions, particularly on industrial, new industrial, new utilities, is a substantial hinderance to the ability to be able to sell natural gas.

Mr. REIF. I think that is an area that has been, I think, underdiscussed in the area. Let me put it that way. The electric industry, for example, hasn't really emphasized this. Canada has been using the select use of natural gas to implement their air emission quality standards, and in Toronto alone by burning natural gas with coal in a 2,100-megawatt unit outside of Toronto they have reduced sulfur and nitrogen emissions 90 percent, at no significant increase, no cost of scrubbers for these old units. They are 1950 steam-generating units.

That would still be available. Baseload natural gas could have a tremendous impact on air quality without providing that electric utility customers will have to pay for scrubbers.

Senator NICKLES. Mr. Gooch, did you have a comment?

Mr. GOOCH. I was just going to follow up with what Mr. Reif had said, that our experience after incremental pricing was imposed was that State by State the States adjusted the rate to be sure that the industrial rates would go up, and I think history is on our side as to what would happen if block pricing came into effect, which is even worse.

And as further evidence in support of my position, when the Commission recently issued the Texas Eastern rate designs decision and put part of the demand charge on an annualized basis they said we certainly hope that the State commissions will continue to treat this as a demand charge and not flow it through. So we industrials really face two devastating hickeys—the D2 in the Texas Eastern rate and, even worse, the block 2 pricing.

Senator NICKLES. Mr. Vlcek?

Mr. VLCEK. I wanted to comment on one thing that's been said in this room a lot of times, particularly by representatives of the distribution companies, and that is how much gas—and pipelines—how much gas is being moved? I don't want to put your staff to a great deal of additional work. I don't have the statistics available here, but I would suspect that a review of those statistics would indicate that the vast majority of that movement is either, A, for other pipelines, B, for industrial users with a switching capability.

Our experience as captive industrials is that we're having a great deal of difficulty in general getting distributors either to move the gas or, secondly, and we have empirical data which I can offer you, the prices that are charged are so onerous that it's very difficult to make these arrangements.

In situations where we move gas to the border of California, for example, for 21 cents, and for us to get it from California to the plants under the current proposals by Southern California Gas it would be $2.

The situation in Michigan, we can get it from Louisiana to the city gate and then the distribution company wants to charge us six times as much as that to get it from the city gate to the plant. Similar situations prevail in Pennsylvania and other States. Pennsylvania has gotten so bad some people are moving the gas by truck. They're going out and buying their own gas fields and arranging for private pipeline transportation.

That's the kind of situation we're dealing with and that's one reason we're so adamantly in favor of part A of this proposal.

Senator NICKLES. I need to wrap this hearing up. One quick question to the LDC's, and we'll give them half a chance to respond, but on the provision that deals with the abrogation or the 25 percent market-out, were you all in favor of that, opposed to it?

Mr. BUNN. Generally speaking, none of the distribution companies believe that they would take a significant reduction in their contracts with pipeline companies even though the option is available. Most of the companies believe that if they took a 25-percent reduction or any reduction in their sales contract they would replace it on the pipelines with some kind of a firm transportation contract because they need that firm transportation on peak to meet their utility obligations.

The problem is what is the mix of transportation and sales, and that's a legitimate concern, and most of the distribution companies in the AGD believe that they would like to see about 85 percent of their gas supplied by the pipeline and about 15 percent of the transportation markets. So that's about the range you're looking at.

One point, if I may, on the transportation issue. We've talked a lot about discriminatory transportation and the thing you want to remember is who is discriminated against. The companies or people who were discriminated against were the captive customers along the point that's over there. And the real issue is who's going to buy that high-priced gas.

And if FERC comes out with a nondiscriminatory transportation program such that everybody has access to the spot market today, I would ask the question as to who's going to buy the high-priced gas, because we're going to move off it as fast as we can get the opportunity to do so.

Senator NICKLES. I almost think you contradicted yourself because initially you said you weren't going to abrogate and now you're going to tell me you are going to abrogate and then replace it with, I guess——

Mr. BUNN. If they give us a nondiscriminatory transportation rate, nondiscriminatory transportation rate, remember I said we're going to buy transportation for sale, we're going to have to get off that high-priced gas. We don't have any choice because nobody will buy it. If they have access to cheaper gas in the field, nobody's going to buy that gas anyhow.

Senator NICKLES. Well, I appreciate all of our panelists' comments. We will keep the record open for an additional 2 weeks to allow witnesses and others, other Senators to ask additional questions. I appreciate your participation before the hearing today.

The hearing is adjourned.

[Whereupon, at 1:35 p.m., the hearing was adjourned.]

[The subcommittee received the following from Leede Oil & Gas, Inc.]

LEEDE OIL & GAS, INC.

1100 PARAGON BUILDING
600 NORTH MARIENFELD
MIDLAND, TEXAS 79701
915 682-2535

September 5, 1985

The Honorable Don Nickles
Chairman, Subcommittee on Energy Regulation and Conservation
Committee on Energy and Natural Resources
United States Senate
Washington, DC 20510

Attention: Mr. Howard Useem

Dear Mr. Chairman:

The undersigned serves as in-house legal counsel for Leede Exploration and Leede Oil & Gas, Inc. ("Leede"), entities which respectively own and operate oil and gas wells in the State of Oklahoma, including many wells which produce from a depth greater than 15,000 feet. Such wells were drilled based upon contractual assurances from the pipeline purchaser of a relatively high, deregulated gas price.

We are concerned that our existing contractual relationship with pipeline purchasers may be jeopardized as a result of the rules proposed by the FERC in RM 85-1. The FERC is confronting too many issues in too short a time period. The effect of its haste in implementing sweeping changes in the natural gas industry will be to encourage pipelines to breach existing lawful contracts on grounds of force majeure.

We respectfully request that the enclosed Comments previously submitted by Leede Exploration and Leede Oil & Gas, Inc. respectively, to the Office of the Secretary, Federal Energy Regulatory Commission, be made a part of the Hearing Record for the Subcommittee's September 19th hearing on the FERC Notice of Proposed Rulemaking, "Regulation of Natural Gas Pipelines after Partial Wellhead Decontrol", Docket No. RM 85-1-000, (parts A-D).

Very truly yours,

Randal M. Kirk

Randal M. Kirk
General Counsel

RMK/rr

Enclosure

Federal Express

LEEDE OIL & GAS, INC.

1100 PARAGON BUILDING
600 NORTH MARIENFELD
MIDLAND, TEXAS 79701
915 682-2535

July 11, 1985

Office of the Secretary
Federal Energy Regulatory Commission
825 North Capitol Street, N.E.
Washington, DC 20426

Re: Docket No. RM85-1-000 (Parts A-D)/Comments of Leede Oil & Gas, Inc.

Gentlemen:

Leede Oil & Gas, Inc. ("Leede") operates many wells in the state of Oklahoma which produce from a depth of greater than 15,000 feet. Such wells were drilled based upon contractual provisions assuring a relatively high, deregulated contract price. In view of the significant mechanical risks encountered in drilling such deep wells, these wells would not have been drilled absent the incentive of the high, deregulated contract price and take-or-pay provisions insuring that significant volumes of producible gas would be sold.

In its Notice of Proposed Rulemaking issued on May 30, 1985 the FERC states as its objective to "level the playing field" for all pipelines by requiring that old, low cost gas be separately billed so as not to afford an advantage for those pipelines with large commitments of such gas and by endeavoring to afford a mechanism for relieving pipelines of burdensome take-or-pay provisions through specification of presumptively prudent settlement conditions. Leede submits that, from a cost pass-through standpoint, it is impossible to "level the playing field" for pipelines if only low cost gas is taken into account. Very significant supplies of gas, particularly high cost, deep gas, are subject to firm contracts which were negotiated and drafted so as to afford the producer ample incentive to assume the enormous risks of deep drilling and which therefore do not contain market-sensitive pricing provisions. In order to avoid creating a new scenario of artificial advantages and disadvantages between pipelines, any final regulations should be equally sensitive to the cost pass-through situation of those pipelines which in accordance with the objectives of the Natural Gas Policy Act of 1978 concluded firm contracts covering significant supplies of high cost, deep gas.

Certainly market conditions have made it more difficult and in some cases impossible for pipelines to profitably market gas subject to such contracts. The impact of changes in supply and demand is fundamental to all commercial transactions, however, and sophisticated businessmen generally take into account the implications of such changes and related business risks in pursuing contractual negotiations. In instances where changes in market conditions have been asserted as a justification for non-performance of contracts by pipelines, the courts have made it clear that contracts cannot be violated simply because a transaction has been rendered unprofitable for one of the parties. Typical of the courts' analyses is the view expressed by the United States District Court for the Western District of Louisiana in Exxon Corp. vs. Columbia Gas Transmission Corporation (#CV-83-1586-L) in refusing to sustain the pipeline's market-based defense on pricing issues--

> "the principle cause of these four contracts, i.e., a certain quantity of natural gas for a certain price, remains intact, in spite of the fact that Columbia's hopes for the marketing of this gas at a commercially profitable level have been dashed. Accordingly, Exxon is entitled to a summary declaratory judgment in its favor as to the price provisions of these four contracts."

It was clearly not the intention of Congress in enacting the Natural Gas Policy Act of 1978 to encourage pipelines to breach existing lawful contracts, and certainly any regulatory provisions endeavoring to do so would be subject to constitutional challenge. In the event that the FERC desires to encourage settlements between pipelines and producers regarding contracts which do not contain market sensitive pricing or take-or-pay provisions, the FERC should encourage pipelines and producers to enter negotiations on a case-by-case basis, recognizing that the original contract between them is a binding agreement which is not subject to unilateral modification by a party dissatisfied with the economic results of the contract. The suggestion of the NOPR that contracts are for the most part susceptible of modification through payments to producers of lump sum settlements is overly simplistic in view of the vast differences existing in the circumstances of pipelines and producers and the background of contracts. Producers who have in good faith incurred enormous expenses and risks on the faith of binding, lawful contracts cannot be expected to waive their contractual right to full performance by the pipeline unless the circumstances applicable to each producer's situation are adequately addressed through a negotiated settlement agreement.

Leede strongly urges the Commission to foster and facilitate contract settlements between pipelines and producers by taking no action to impede negotiations for mutually acceptable revisions to existing contracts. The FERC should recognize that any settlement which affords price relief or other concessions to the pipeline which are not required by the contract is entitled to a presumption of prudence.

Very truly yours,

LEEDE OIL & GAS, INC.

Randal M. Kirk

Randal M. Kirk
General Counsel

RMK/rr/19

LEEDE EXPLORATION

1100 PARAGON BUILDING
600 NORTH MARIENFELD
MIDLAND, TEXAS 79701
915 682-2535

July 12, 1985

Office of the Secretary
Federal Energy Regulatory Commission
825 North Capitol Street
Washington, D.C. 20426

Comments in response to NOPR
Docket No. RM85-1-000 (Parts A-D)

Gentlemen:

Leede Exploration is a family-owned Texas general partnership of which I am the Managing Partner.

I recognize that Parts A-D of the Proposed Rulemaking 85-1-000 are interrelated. My comments herein are limited to Part B, Take-or-Pay, insofar as it relates to a single gas field in which our primary purchaser is a major interstate pipeline company, "The Pipeline Company". Leede Exploration will suffer severe economic hardship as to our ownership in such field if our current contractual rights are abrogated or, in the alternative, if our current good-faith efforts to arrive at a mutually satisfactory settlement with The Pipeline Company are thwarted by any presently unpredictable action of the FERC in a final Rulemaking.

In 1979, Leede Exploration proposed the drilling of below-15,000', high-cost gas wells in the Northeast Mayfield Field, Beckham County, Oklahoma in response to incentives provided by The Pipeline Company pursuant to provisions under the National Gas Policy Act, particularly with regard to price and minimum takes. Contracts were negotiated and/or amended with The Pipeline Company which provided the economic incentive to develop the field. Leede Exploration and its participants now have expended $154 million and have completed 12 deep gas wells including the three deepest gas wells in the state of Oklahoma (perforations down to 25,000' below the surface). As best we know, there are only two wells in the world successfully completed at deeper depths.

Leede Exploration in effect has participated in turning a serious nationwide gas shortage of just a few years ago into a current surplus. Furthermore we must spend at least $50 million more on this development in the next 18 months in order to fulfill our existing drilling commitments and to optimize the use of a $15 million gas plant and related facilities to extract CO_2 and H_2S, contaminants in our gas stream. Under our existing contracts with The Pipeline Company, the price and take provisions make the enormous risks and costs worthwhile. Very little gas has been sold to date under such contracts, however, largely because of a pending dispute between The Pipeline Company and Leede Exploration relating to take-or-pay and pricing.

We recognize the problems of The Pipeline Company in attempting to dispose of our gas under current market conditions. At the same time, we are suffering major financial problems as a result of the commitments we have made and must continue to make. The Pipeline Company and we have been attempting to resolve our common problem through mutual give-and-take in negotiations which have extended over most of 1985. Given a little more time, and perhaps the blessing of the FERC, I feel certain that the problem will be resolved. On the other hand, if the current spot-market price for gas were all we received for our Northeast Mayfield sales, the results ultimately could be financially ruinous to

Leede Exploration and we would be compelled to seek recourse in the Courts to enforce our contractual rights.

The deep drilling we have succeeded in doing has been considered too risky by certain major oil companies who have farmed out their rights to us. The pity is that, having accomplished what we set out to do in the face of enormous risk, we now face dire consequences if our gas contracts were to be abrogated through action of a regulatory body. While I realize that the FERC is not proposing contract abrogation per se in its Proposed Rulemaking, the FERC also is not specifically addressing sanctity of contracts, a right guaranteed under the Constitution and further upheld for all of us in the Dartmouth College Case, which was heard before the United States Supreme Court with Daniel Webster making the case for the principle which prevailed.

Essentially then, we are concerned that nothing occur as a result of the Proposed Rulemaking which would purport to supercede rights we currently have by law. We have always abided by sanctity of contract, recognizing that the framework within which any contract is consummated relates to the economic conditions then prevailing. We are not happy with some of our old contracts (one in particular that comes to mind calls for a price of 16¢/MCF) but we still operate under those contracts and neither the FERC nor any of the purchasing pipeline companies so far has come to us offering to bring those old contract terms up to today's prices or market standards. If the basic sanctity of contract can be upheld through application of the "X%" or the "Y%" in the take-or-pay part of the Proposed Rulemaking, all well and good. (For this to work in our case, "Y" would have to be close to 100% and we and The Pipeline

Company would have to agree on many other judgmental factors). On the other hand, if Leede Exploration and The Pipeline Company, both acting in good faith, can resolve our problems without a formulated mandate from the Federal Energy Regulatory Commission, that should also be well and good.

Overall, the FERC's basic objectives appear fundamentally desirable in the long-run but, in the short term as well as the long term, the FERC must take constitutional rights of all parties into account. In our case, this simply means that our existing contractual rights must be vigorously asserted if, as a result of regulatory impediments, we fail in our current efforts to renegotiate our existing lawful contracts with The Pipeline Company. From a broader perspective, all producers should be protected in this regard.

Respectfully submitted,

Edward H. Leede

EHL/pm
Original + 14 copies